

## **Disclaimer**

**The information in Department of Revenue's field audit manual is provided for the guidance of audit staff. However, the Audit Division reserves the right to depart from the standard processes outlined herein when and as it deems such departure to be warranted in the circumstances. Any such departure will be done with the approval of the Audit supervisor and or manager and in no way undermines or invalidates any audit finding so long as all statutory requirements are met. The field audit manual does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated. The field audit manual and the information contained therein may neither be cited to support an audit position nor may it be relied upon by a taxpayer. Furthermore, the field audit manual does not constitute a public policy statement or "other written guidance issued by the commissioner" as described in or for purposes of chapter 62C, section 26(j).**

# Chapter 1

## Overview

This manual is intended to provide field auditors with an understanding of their accountabilities and responsibilities in the conduct of audit assignments. The primary focus is on auditing standards and procedures established by the Audit Division to ensure professionalism and integrity in audit operations.

The Field Audit Procedures Manual is to be utilized in conjunction with the Division's Audit WorkBench (AWB) or Electronic Audit Case Folder, the Discover Tax Warehouse (DTAX) and the Department's computerized MASSTAX Declaration System (MASSTAX).

Auditors are expected to be familiar with all internal forms, definitions and procedures described in the Audit WorkBench (AWB) Manual and the MASSTAX Phase II Declaration System Manual.

This manual is the property of the Massachusetts Department of Revenue. It must be turned in to your immediate supervisor upon leaving the Audit Division or the Department.

### **Mission Statement**

The Audit Division maintains a strategy that assures the citizens of the Commonwealth that our system of taxation, relying on voluntary compliance, will remain effective and efficient.

### **Audit Elements**

An auditor's primary function is to determine if a tax has been correctly reported. Audits should be completed in a professional and efficient manner and should create the least possible inconvenience for taxpayers.

Five essential elements are used to meet audit objectives:

**Taxpayer Relationships.** The benefit derived from developing a good relationship with a taxpayer is two-fold. The taxpayer tends to become more comfortable with the audit situation, which allows the audit process to flow more smoothly, and the auditor is able to secure taxpayer cooperation, which enables timely completion of the audit.

**Planning Activities.** Planning an audit begins when an audit assignment is received. It is very important that all audit activities, including pre-audit preparation, be documented in the Audit WorkBench (AWB)-Case Log and Case Plan (See Chapter 3, Audit Planning and Documentation-The Electronic Audit Case Folder).

**Examination of Records.** Gathering and evaluating sufficient records is essential for providing an adequate basis for determining the accuracy of the tax returns filed. The auditor should always discuss and review with the taxpayer what records may be available in electronic format. The use of auditing tools such as DOR's Computer Assisted Auditing Techniques (CAATS) is encouraged in an effort to streamline the audit process. While the use of a full scale CAATS audit may not be possible, the auditor should consider how the use of any available electronic records might enhance the ability to complete the audit in the most efficient manner (See Specific Chapter for Audit Procedures by Tax Type).

**Application of Law.** An auditor must be knowledgeable with the requirements of the law administered. Copies of all tax laws and the MASSTAX Legal Guide, which provides DOR written pronouncements and regulations, are available to every auditor and updated annually. The Legal Library is also available on DORNET.

**Documentation.** Documentation is used to compile pertinent facts discovered during an audit. A well-documented audit will consist of a complete record of evidence examined by the auditor to support any findings on the audit work papers included in the electronic audit case folder through Audit WorkBench (AWB)-Attachments. Also, document any oral statements made by the taxpayer that may be important to support any audit findings through the Audit WorkBench (AWB)-Case Log (See Chapter 3, Audit Planning and Documentation-The Electronic Audit Case Folder).

## **Audit Process**

**Audit Assignment.** The first step in the audit process occurs when the auditor receives the audit assignment through My-Inventory in Audit WorkBench (AWB). The source of audit assignment and audit period selected must be documented in the Audit WorkBench-Case Log and audit narrative along with indicating this step on the Audit WorkBench-Case Plan (See Chapter 2, Pre-Audit Research).

**Pre-Audit Research and Review.** This research period is the step in which the auditor reviews information about the taxpayer and/or the business to be audited. Information can be obtained from DTAX, MASSTAX, reviewing prior audit folders; if available, and the Internet (See Chapter 2, Pre-Audit Research).

**Taxpayer Contact.** The first contact with the taxpayer occurs after the initial pre-audit research and review has been completed. The auditor calls or writes the taxpayer to arrange an appointment to begin the audit. A pre-populated Notice of Audit Appointment and Checklist/Information Document Request are created through Audit WorkBench (AWB)-Notice Generation (See Chapter 2, Pre-Audit Research).

Note: All contact information, especially Power-Of-Attorney information, can be entered into Audit WorkBench-Contacts which will transfer the contact information to the

recipient data field in Notice Generation. This creates a copy of a particular notice for the taxpayer as well as the recipients, i.e. POA.

**Opening Conference.** The first face-to-face meeting with the taxpayer occurs during the opening conference. The auditor will outline the audit process for the taxpayer, obtain more information regarding the taxpayer's business, answer taxpayer questions, discuss records required including the availability of electronic records and ask any other questions that will help in completing the audit (See Chapter 4, Opening Conference).

**Examination of Taxpayer Records.** It is important to determine how the taxpayer calculated the reported amounts. The auditor should have the taxpayer explain how the return was prepared. The auditor should reconcile appropriate accounts with the taxpayer's filing history after establishing the validity of summary records. Work papers, documents received from Taxpayers, all correspondence, and any other pertinent documents should be included in the electronic audit case folder in Audit WorkBench (AWB)-Attachments (See Specific Chapter for Audit Procedures by Tax Type).

**Exit Conference.** Upon completion of the field work, the taxpayer is given the opportunity to meet with the auditor's supervisor or manager and discuss the results of the audit and administrative remedies including Administrative Procedures (AP) 633-the Guidelines for the Waiver and Abatement of Penalties and Pre-Assessment conference and/or settlement requests (See Chapter 5, Audit Completion-Documentation of Audit Findings & Administrative Remedies).

**Audit Completion.** This step entails the process of summarizing the results of the examination. The auditor prepares the electronic audit case folder for review by attaching the above mentioned work papers, and the audit narrative. In cases where a Notice of Intention to Assess (NIA) will be issued, final assessment summary and assessment interface details are needed to transition the case from Audit WorkBench (AWB) to AAHT in MASSTAX. Assessment interface is not required for cases where returns are secured (See Chapter 5, Audit Completion-Documentation of Findings & Administrative Remedies).

**Audit Review.** When the audit write-up is completed, it will be reviewed through Audit WorkBench (AWB) by the supervisor or designated approver in the hierarchy based on dollar delegation. The purpose of the review is to ensure that the audit is technically, procedurally and mathematically correct. Once the case is approved, the case will be validated and interfaced through Audit WorkBench (AWB) resulting in the issuance of the NIA which is sent to the taxpayer (See Chapter 5, Audit Completion-Documentation of Findings & Administrative Remedies).

**Contested Audits.** If the taxpayer disagrees with the audit findings, the taxpayer and/or taxpayer's representative may request a conference in accordance with MGL, Chapter 62C, section 26(b). The conference conducted with the Office of Appeals (OOA) gives

the taxpayer the option of a pre-assessment conference and/or settlement consideration. The electronic audit case folder will be forwarded to the Office of Appeals (OOA) through Audit WorkBench (AWB) for the appropriate action necessary (See Chapter 5, Audit Completion-Documentation of Findings & Administrative Remedies).

### **Statute of Limitations for Assessment**

Massachusetts has established a uniform three-year statute of limitations on all taxes. The statute expiration date is generally three years from the statutory due date of the return or the date the return was filed, whichever is later. In the case of a false or fraudulent return or failure to file a return after notice is given, an assessment can be made at any time in accordance with G.L. c.62C, section 26 (d) and section 28. In the case of an underreporting of gross income by 25% or more on income returns or underreporting of transactional tax (including excise tax of banks, public utilities and insurance companies) by 25% or more, an assessment can be made within six years in accordance with G.L. Chapter 62C, section(s) 26 (h) and (i).

In determining the expiration date for assessment on any return filed after the statutory due date, auditors must verify and confirm the actual date of filing. The imposition of late file penalties is proposed for any return filed after the statutory due date and lacking the Commissioner's granting of an extension of time for filing said return.

### **Non-Filer Enforcement Criteria**

**General Rule - Seven-Year Look-Back Policy.** When a taxpayer fails to file a required tax return, the Commissioner may make an assessment of tax at any time, without giving notice of his intention to assess for any taxable period for which a return was due. See, G.L. Chapter 62C, section 26(d). The statute does not limit the number of past due returns the Commissioner may assess. However, in any instance involving a failure to file, the Commissioner generally seeks to balance considerations of taxpayer compliance and appropriate agency resource allocation. In keeping with these general considerations, the Commissioner established policies regarding taxpayers that have failed to file returns due for past taxable periods: a seven-year look-back policy for all non-filer resident taxpayers and non-resident taxpayers that the Department discovers have failed to file returns, a three-year look-back policy for non-resident taxpayers and foreign corporations or other foreign entities that voluntarily disclose past due filing obligations, and a separate look-back period (4-7 years) for individual use tax obligations (See TIR 03-17).

When the Commissioner determines that a taxpayer has failed to file tax returns which were required, the Commissioner may assess the taxpayer with respect to returns due during the most recent seven years. The seven-year (i.e., eighty-four month) look-back period will commence with the final day of the most recent taxable period for which the taxpayer was required to file a return for the tax type in question. The look-back period shall be determined (without regard to extensions) as of the date the Commissioner first contacted the taxpayer in writing concerning such tax. If an individual taxpayer or

corporation voluntarily files some or all of its overdue returns without first being contacted by the Commissioner, the look-back period will be determined as of the date the taxpayer filed one or more returns with the Commissioner.

When a taxpayer was previously required to file returns but is no longer so required, the Commissioner will assess the taxpayer for the final seven years (i.e., eighty-four months) for which the taxpayer was required to file returns, provided that the Commissioner did not contact the taxpayer concerning such returns before the due date for its final return. The above policy does not affect assessments which the Commissioner might otherwise lawfully make (e.g., as to returns which are subsequently required, insufficient returns and the failure to pay a required tax). Non-resident individual taxpayers, foreign corporations and other entities that voluntarily disclose a past due filing obligation may qualify for the three-year look-back policy.

**Factors Supporting Assessment of Additional or Fewer Taxable Periods.** In certain instances the Commissioner, notwithstanding the policies stated above, may require additional returns to be filed, up to and including all past due returns. Likewise, in certain circumstances the Commissioner, notwithstanding the policies stated above, may require fewer than seven years of past due returns. In both cases, the Commissioner will consider pertinent facts and circumstances, including:

1. the degree of flagrancy and history of the taxpayer's noncompliance;
2. the existence of income from illegal sources;
3. special circumstances peculiar to the specific taxpayer, or peculiar to the taxpayer's business or industry;
4. the cost to the Commissioner to secure the tax revenue through means other than voluntary disclosure;
5. whether there was a basis for any reasonable doubt on the part of the taxpayer as to its filing obligation;
6. failure to file returns and remit withholding tax pursuant to Chapter 62B, section 2;
7. failure to file returns and remit trustee type taxes collected but not paid over (such as sales tax, meals tax or room occupancy tax);
8. an attempt in any manner to evade or defeat any tax, or a willful failure to collect, account for and pay over trustee taxes (including instances punishable pursuant to Chapter 62C, section(s) 73 (a) and (b));
9. willful neglect to file returns despite reasonable cause to know of a filing responsibility; and
10. sporadic filings not justified by objective circumstances.

### **Statutory Authority for Assessment**

A framework of the assessment provisions under G.L., Chapter 62C authorizing the Commissioner to assess a tax and the notice requirements with time frames in which an assessment is to be made is shown below.

## Statutory Authority for Assessment

<b>[1] ASSESSMENT CRITERIA</b>	<b>MGL, Ch.62c STATUTORY AUTHORITY FOR ASSESSMENT</b>	<b>NOTICE OF INTENTION TO ASSESS REQUIREMENTS</b>	<b>ASSESSMENT TIME FRAME</b>
Verification of return determines proper tax not reported.	26(b)	NIA required	Within 3 years after the return was filed or the statutory due date, whichever is later.
Filed returns/mathematical or clerical error.	26(c)	NIA not required by law.	Audit policy is to issue NIA Within 3 years after the date the return was filed or the statutory due date, whichever is later.
Failure to file return after Commissioner notification. (NFF).	28	NIA not required by law. Audit policy is to issue NIA only in those cases where the filing requirements of a foreign corporation or non-resident are in dispute.	Anytime
False or fraudulent return filed with intent to evade a tax or failure to file a return.	26(d)	NIA not required by law.	Anytime
Filed returns/understatement of gross income by 25% or more	26(h)	NIA required	Within 6 years after the date the return was filed or the statutory due date, whichever is

Filed returns/understatement of tax by 25% or more.	26(i)	NIA required.	later. Within 6 years after the date the return was filed or the statutory due date, whichever is later.
Tax in jeopardy	29	NIA not required by law.	Immediately, whether or not the time otherwise prescribed by law for filing the return and paying tax has expired.
Determination of a filing of an incorrect or insufficient return after Commissioner notification (NIR).	28	NIA not required by law.	Audit policy is to issue NIA. Within 3 years after the date the return was filed or the statutory due date, whichever is later.
Filing of a false or fraudulent return with a willful intention to evade tax.	28	NIA not required by law.	Anytime

## Extending the Time for Assessment of Taxes (Waivers)

### Introduction

Statute control is critical to the successful operation of every group within the Audit Division. The Commissioner has three years from the date a return is filed or the date the return was required to be filed, to assess additional taxes (See G.L. Chapter 62C, section 26(b)).

Accordingly, it is incumbent upon all employees to know their role and responsibilities regarding statute protection and the handling of consent waivers, so that the Commonwealth's interest can be protected.

If, before the expiration of the time prescribed for the assessment of any tax, the Commissioner and the taxpayer consent in writing to extend the time for the assessment of the tax, the Commissioner or his duly authorized representative may examine the books, papers, records and other data of the taxpayer, may give any notice required and may assess the tax at any time prior to the expiration of the extended time.

The period so extended by the Commissioner and the taxpayer may be further extended through the use of consent waivers which are subsequent agreements in writing made before the expiration of time last extended. The waiver is a document signed by a person with legal authority to waive the statutory time requirement during which a notice of assessment must be issued by the Department. If, as a result of such examination, the Commissioner determines that the taxpayer has overpaid any tax, he shall reduce the assessment accordingly and refund the overpayment. (See G.L. Chapter 62C, section 27).

Consent to Extending the Time for Assessment of Taxes (Form A-37) also known as the waiver is signed by the case supervisor or manager and the authorized taxpayer representative and constitutes a legal document which should be date stamped when received. It establishes a new expiration date for specific reporting periods to allow for the completion of an audit.

Note: In circumstances where the absence of a supervisor, manager or director would compromise the statute of limitations, the auditor should sign and date the agreement. The auditor is allowed to execute a waiver by the DOR's Delegation of Authority.

Note: Waivers faxed, photocopied and received electronically through secure mail are acceptable. However, securing the original waiver is preferred.

**All Waivers Must Be Scanned and Attached in the Electronic Audit Case Folder.**

## **Detailed Procedures for Protecting the Statute of Limitations (SOL)**

### **General Information**

- The Consent Extending the Time for Assessment of Taxes can be retrieved from Audit WorkBench- Notice Generation.
- The form (1) should be returned with original signature(s).
- Upon execution, the auditor will submit Form A-37 (waiver) to the supervisor/manager for approval and the supervisor/manager or their designee will make the appropriate SOL update in Audit WorkBench-Period Details: Statute of Limitations. The form (1) will be scanned and attached to the electronic audit case folder then sent to the taxpayer.
- All data in Audit WorkBench pertaining to statute control must be verified by someone other than the person actually entering the information to the system. Management must approve all SOL changes before edits can be made by the designee.

- Any subsequent changes to an executed agreement must be effected by the execution of a new agreement.
- This agreement must be executed at least 31 days before the original statute expiration date of the period(s), or before the extended expiration date(s) on the previously executed agreement(s), if an NIA has not already been issued. This is to ensure that a timely assessment can be made pursuant to Massachusetts General Laws, Chapter 62C, section 26(b).
- Upon assignment or at any time during the course of the audit, the auditors are responsible for securing taxpayer agreement to an extension of time for all report periods in which there is less than 90 days to the date of expiration for assessment.

Note: Only in unusual circumstances should the statute of limitations be allowed to go below 90 days.

### **Initial SOL Determination**

The DTAX Warehouse is the key database that houses information that is processed through MASSTAX including return file dates which dictates the statute of limitations for returns within audit periods. However, checks and balances are essential to ensure that all information entered into Audit WorkBench is correct. The effective dates of all filed returns in Audit WorkBench should be verified against the data in MASSTAX.

The following procedures are to ensure that safeguards are present during all phases of statute protection.

Unassigned Inventory - "Unassigned inventory" will constitute inventory that has not been assigned to an auditor through Audit WorkBench by his/her supervisor and does not have an established SOL or earliest date for expiration.

### **Assigned Inventory**

- Once a case is assigned, inventory and statute control become the joint responsibility of the supervisor and the case auditor. However, the auditor bears the primary responsibility for monitoring and protecting the SOL on all cases in his/her possession.
- To determine and protect the audit period(s) for transactional cases, the case supervisor or designee will associate the periods to the case through Audit WorkBench-Period Details: Create Periods or Manage Periods and will enter the SOL date after reviewing the expiration date chart which displays the first and last day of the audit period based on the current period due which is supplied to each auditor at the beginning of the each calendar year.
- Once the periods are associated, return to the Period Details screen and review the effective date of the filed returns to establish the SOL.

- Once the SOL is established, enter the SOL in Audit WorkBench-Period Details: Statute of Limitations. The auditor/supervisor should select realistic first audit periods and expiration dates for cases. Exact expiration dates should be determined from your review of the applicable MASSTAX screens, Discover Tax Warehouse and examination of documentary evidence, i.e., tax returns, canceled checks.
- To determine and protect the audit period(s) for income based taxes the auditor will refer to the actual return and/or electronic copy of the return, and:
  - if a return is signed and dated on or before the statutory due date, without extension, the date for SOL purposes will be the statutory due date.
  - if a return, filed on extension, is signed and dated before the extension due date, the date for SOL purposes will be the signed date.
  - if a return is signed and dated after the due date, with or without extension, then that date will control for SOL purposes, unless the signed date appears to be an error.
  - if a return does not contain a signed date, then the internal date stamp should be used. If the return does not have an internal date stamp, then the MASSTAX assessment date should be used. However, if the return is date stamped within the DOR grace period then the statutory due date should be used.
  - Note: Internal date stamps or processing dates should not be utilized until it is proven that the signed and dated return is incorrect.
  - Note: The auditor should examine each return under audit to determine the earliest expiration date. The oldest period filed is not always the oldest period under audit.
  - Failure to File Cases - When an auditor is assigned the case of a non-filer, the Non-Registrant check box in Audit WorkBench-Period Details should be used to indicate that the taxpayer is a Non-Registrant or Non-Filer. This will allow the SOL to be null for reporting purposes. When returns are secured, the SOL date must be edited immediately to reflect the proper SOL date.

**Form Completion** (\* Fields to be pre-populated based on the Audit WorkBench case information.)

- Taxpayer Name\*: Enter the correct name of the entity. If a combined return, enter the principal reporting corporation and subsidiaries and on an attached schedule listing the subsidiaries and have the taxpayer sign.
- Address\*: Enter the correct mailing address of the entity.
- Taxpayer Number\*: Enter the FID business number or social security number if applicable.
- Tax Type\*: Enter the correct statutory citation of the tax type being audited and Chapter 62C.

- Reporting Period(s)\*: Enter the beginning and ending dates of the report period(s) being extended based on the taxpayer's reporting methods applicable for the tax type:
- Extended To: Enter the date to which the assessment date for the period is to be extended.

**The maximum time extension for any report period is 12 months per Division policy. Any additional extension of time per subsequent agreement must be approved by regional management.**

Note: The actual date of filing for each return period under audit must be determined by the auditor with the earliest date for expiration of the time for assessment being entered into Audit WorkBench-Period Details: Statute of Limitations. The case auditor and supervisor/manager are jointly responsible for establishing, monitoring and protecting the statute of limitations for assessment on each return period assigned for audit.

In cases where the actual date of filing cannot be firmly established at the time of assignment, the auditor is to determine the time allowed for assessment based on the statutory due date for filing such return(s) pending the establishment of the actual date of filing.

## **Handling of Waivers**

### **Proof of Claims Must be Submitted before the Bar Date**

- In a case where the taxpayer declares bankruptcy while the audit is in progress, the extension date on the waiver should not be beyond the bar date. However, if an extension has already been obtained that is beyond the bar date, the auditor should take extreme care to inform the supervisor so that proper documentation can be timely submitted to the Bankruptcy Unit to file a proof of claim.

### **Failure of the Taxpayer to Execute Waiver**

- If a taxpayer fails/refuses to properly complete and submit an extension of time form within twenty days from date of mailing/delivery, the case auditor is responsible for bringing this fact to the attention of the supervisor/manager for a determination on whether:
    - Additional time should be granted to properly execute the waiver;
    - There exists sufficient information on which to proceed with the issuance of a Notice Of Intention To Assess (NIA) or;
    - In those instances where no field time has been logged, periods may be deleted from the case assignment.
- Proper documentation will be maintained in the electronic audit case folder to

evidence and support the actions and decisions relied upon in the disposition of this issue for each audit assignment.

### **Processing of Waivers Signed and Dated by Taxpayers**

- The taxpayer or the taxpayer's authorized representative should sign the agreement.
- The case supervisor/manager should sign and date the agreement as a representative of the Commissioner after it is signed by the taxpayer representative. Auditors may sign the waiver per DOR's Delegation of Authority.
- The person signing as "Taxpayer" must be authorized to sign the document per the Power of Attorney (Form M-2848).
- Upon receipt of the waiver (one), the auditor date stamps the form and submits the waiver to his/her supervisor/manager for review and approval. The supervisor/manager or their designee makes the appropriate SOL update in Audit WorkBench.
- Once the supervisor/manager or their designee makes the appropriate SOL update, the executed waiver must be scanned and attached to the proper electronic audit case folder in Audit WorkBench.
- Once the appropriate SOL update is made and the executed waiver is scanned and attached, the fully executed waiver is sent to the taxpayer.
- Where a waiver is obtained during the conduct of a field audit, the auditor must indicate in the Audit WorkBench-Case Log and Case Plan that the waiver has been executed, the SOL was updated and taxpayer has received a copy of the executed waiver.

### **Processing of Office of Appeals (OOA) Waivers (Form B-37)**

- The processing of the Office of Appeals (OOA) waiver forms for cases involving section 26 (b) pre-assessment conference requests and/or settlement consideration is essentially the same. The only exception is that the responsibility of preparing, forwarding, and processing these forms rests with the supervisor/manager since the case has been subjected to exit conference procedures (See Chapter 5, Audit Completion-Documentation of Findings & Administrative Remedies).
- For all Form B-37's, the SOL/Waiver date to be entered on Audit WorkBench is 12/25/2027.

## **Monitoring the SOL**

### **Reports and Memos for Monitoring the Statute of Limitations**

- The Statute Protection Report is available through Reports Navigation in Audit WorkBench. Management can access this report on a weekly basis to monitor the Statute of Limitations (SOL). At the end of each month, the auditor is responsible for reporting on all cases that have 90 days or less remaining on the statute. The auditor must furnish the supervisor a written response concerning the status of the case.
- Supervisors and managers are responsible for monitoring the SOL through the mandatory review of cases in progress and Technical Time Reports timely to ensure that:
  - no cases will expire before the first day of the next month;
  - waivers are being secured, if an NIA is not going to be issued within the month; and
  - all updates have been done on waivers received.
- Management is responsible for conducting monthly reviews of the statute of limitation report to enable timely corrective action in protecting against the expiration of the statute of limitation for assessment on any case in which taxpayer contact has been made.
- Each supervisor or manager will prepare a monthly SOL report to be submitted to the Chief of Bureau.

#### **Footnote:**

See Assessment Regulation: 830CMR 62C, 26.1.

## Chapter 2

### Pre-Audit Research

#### Introduction

The auditor becomes familiar with the taxpayer's filing history in this phase of the audit process. The auditor should perform a review of the taxpayer and the business to be audited before the taxpayer is contacted. Additional research continues through taxpayer contact and preliminary testing.

Information for review is available from various sources: current and prior audit files; audit management; the Internet; MASSTAX; DTAX (i.e., financial information, demographic information, business details and accounts); and other governmental agencies as well. This information should aid the auditor in:

- Learning more about the taxpayer's reporting methods and business operations;
- Understanding the taxpayer's filing and payment history;
- Establishing preliminary objectives for the audit plan; and
- Identifying and researching possible industry specific problem areas.

#### **Audit Workbench-Create/Associate New Period Case Creation**

When a taxpayer has been selected for audit, the supervisor/manager or their designee will create and associate the audit period and SOL for each case assigned using the most current audit period end date. Once the audit period has been associated, the auditor will be notified through Audit WorkBench (AWB)-My Inventory and an auto case log entry will be created and entered into the Audit WorkBench (AWB)-Case Log.

The source of audit is assigned during Audit WorkBench (AWB)-Case Creation through the Case Attributes pane. The source of audit assignment whether from a referral or from an automated RFQ should be documented by the auditor in the Audit WorkBench (AWB)-Case Log through a manual case log entry. The source of audit should be included in the audit narrative and indicated as such in the Audit WorkBench (AWB)-Case Plan.

During the case creation process the case type, the case sub type and the reason for the audit also known as the case attributes dictates how the electronic audit case folder is assembled in other words these case attributes associate the proper Case Plan, Notice Templates and Approval Hierarchy to each case in Audit WorkBench.

## **Establishing Statute of Limitation SOL**

Once the SOL has been established for the periods associated to a case, the SOL will be tracked in Audit WorkBench. Management or their designees will have access to run the Statute Protection Reports which are used to monitor and protect the Statute of Limitation for periods under audit.

## **Case Log**

Once the case has been assigned, the auditor must record all audit activity in the Audit WorkBench (AWB)-Case Log on a daily basis. A normal working day should be recorded as 7.5 hours and designated as field time, office time or telecommuting using the location drop down menu in the Case Log entry pane.

The Case Log will automatically record case actions taken within the electronic audit case folder as designated within the Audit WorkBench Manual. The audit hours charged to a case must be recorded on a daily basis through a manual case log entry. Edits and deletions can be made to manual Case Log entries only.

A complete review of the Case Log can be accomplished by sending the Case Log to an HTML file to view entries and details.

## **Discover Tax (DTAX) & MASSTAX Taxpayer History**

The history is a computer-generated summary of all transactions relating to a particular taxpayer account. Each tax return filed becomes a part of the tax history. The DTAX warehouse contains a history of all taxes recorded within the MASSTAX system for transactions posted to taxpayer accounts after 1998. To review this information, access Audit WorkBench to find a particular taxpayer. Scroll down the Accessed Portfolio node to gain access to all of the DTAX nodes such as tax filings and line item details, ID#'s, asset information, vehicle registration information and summaries of existing Audit WorkBench cases.

The auditor should determine if the filing history is current in order to have the latest updated information and to identify delinquent periods requiring enforcement action.

The auditor should note any tax types that may apply to the taxpayer but which the taxpayer has not registered. The auditor must resolve all registration and filing issues during the course of the audit.

The auditor should note any areas in the taxpayer history that are out of the ordinary. For example, a period with a self-assessment that is out of line with other periods (recognizing seasonal variability). The auditor must investigate and resolve all questionable tax reporting issues.

If a prior audit exists, the MATIS information will be recorded in the MASSTAX system.

If a business commenced operations or opened a new location during the audit period, the auditor should determine on audit if any business activity occurred prior to the registration date and how it was reported. In addition, there may be issues with recordkeeping, reporting the correct tax or income apportionment.

The Standard Industrial Classification Code (SIC) is found on the DTAX under Business Information and is also found on the DLII screen in MASSTAX. This information should be compared to the business description stated on the income/corporate return. This code and description are useful in determining the area of law or industry that may require pre-audit research.

If a business ceased operations during the audit period, an auditor should review transactions involving the liquidation of assets and distributions to shareholders for the purpose of identifying audit issues to be addressed on audit or the referral to another tax area.

The return data will be listed by period for each business entity or business location that was active within the audit period. A return period that is omitted or missing, indicating a delinquency, must be investigated and resolved on audit.

When MASSTAX indicates a 610R within the audit period then the period would still be within the general SOL and the taxpayer would be required to have records for that period. Consequently, you may inquire about the status of any return within the audit period. For periods outside the audit period the following general rule applies, non-filer assessments should not be made after the posting of a 610R unless the auditor has compelling information about the period in question that would conclude otherwise. In such instances, the auditor should discuss the matter with his/her supervisor or manager and only proceed with a non-filer assessment if given explicit direction to do so.

In an effort to maintain an accurate and current taxpayer history and to avoid duplication, auditors are required to comply with the following procedures during the audit cycle.

**Each time a taxpayer record is retrieved in MASSTAX:**

- Browse "Case Notes" (CSNT) and "Taxpayer Notes" (NOTE) to determine the actions already taken on the taxpayer by any other audit region or bureau within the Department of Revenue.

**Upon assignment of a case:**

- Enter a "Taxpayer Note" (NOTE) to identify the Audit WorkBench (AWB) Case ID number, name of auditor assigned to the case, the date the case was assigned and the auditor's region and telephone number.

**Upon issuing either a Notice of Inquiry Letter, Notice of Failure to Register, Notice of Failure to File, or a Notice of Insufficient Return:**

- Enter a "Taxpayer Note" (NOTE) to document the fact that these notices were issued. The "Taxpayer Note" should include, but not be limited to, the name of the notice, date of issuance, tax type and periods.

**DTAX Information**

The information found in the data warehouse is a valuable research tool. The taxpayer demographic portfolio allows access to the DTAX Research component. The following research tools are available and updated as changes to a particular demographic occur and should be used to assist an auditor with his/her pre-audit research activities:

- The financial information provides accounting period details for returns posted to MASSTAX.
- The source data information provides a listing of the source origination for financial information warehoused.
- The relationship information provides a listing of entities "related" including Federal Identification Numbers.
- The asset information provides Registry of Motor Vehicle information including plate numbers and vehicles identification numbers for each vehicle registered to a particular entity.
- The accounts and attributes information provide tax registration history for both federal and state tax types including the effective date of the registration.
- The sales information is provided on a yearly basis by United States Customs.
- The notes information provides a means to enter manual notes relevant to the taxpayer.
- The taxpayer cases information provides the prior audit activity records as well as the current audit records posted to Audit WorkBench.

**MASSTAX Terminal Inquiries**

There is a great deal of information available to the auditor through terminal inquiry. The information used in an audit is not limited to the account being audited. Inquiries can be made to obtain information on related entities, customers and vendors. This section references required inquiries and data purification action required on audit as well as pre-audit activities. Data Purification is a mandatory component of the audit process. Identification and resolution of incorrect data should be conducted as early as possible

during the course of the audit and must be documented in the completed electronic audit case folder.

Any incorrect financial transactions should be corrected using the following forms:

Financial Transactions Corrections - TP-2

Period Summary Corrections - TP-6

Financial Transaction Transfer - TP-11

All forms should be prepared and submitted electronically to the Audit Division's designee for processing and included in the electronic case folder through Audit WorkBench (AWB)-Attachments.

Additional screens are available within the MASSTAX Systems for your use as necessary in the performance of research or other assigned duties.

## **Prior Audits**

The auditor can determine if there has been a prior audit by checking the MASSTAX audit history screen (AAHT). Additional information can be obtained from terminal inquiries including "Case Notes" (CSNT) recorded by another division and reviewing DTAX for completed case activity on Audit WorkBench.

If there has been a prior audit:

- Note the prior audit period to avoid re-auditing the same periods.
- Obtain prior audit case folder and review findings. Discuss them with the taxpayer to determine if corrective action has been taken. Note if corrections were made. Often, there is a period early in the audit, prior to the change, where adjustments are necessary.
- Review prior audit information via the View Link on Audit WorkBench (AWB) cases.
- If the taxpayer disagreed with the audit, follow the audit through the appeals process to see how appellate decisions affected the audit.
- Study audit procedures, plan and notes of the prior audit to:
  - become familiar with records retained;
  - use as a guide to help estimate the time required for completion; and
  - see if the taxpayer contact is the same as on the prior audit. If not, this change may indicate policy or reporting procedure changes in the audit period.

A prior audit should not serve as a blueprint for the current audit. Changes in tax law and business operations occurring since prior audits are important areas to cover. Researching the Legal Library found on DORNET can assist in identifying recent changes in tax laws through Letter Rulings, Technical Information Releases, DOR

Directives and recently enacted Regulations. The prior audit can be used to enhance the current auditor's use of time by identifying records examined, the difficulties of certain audit methods and areas where no errors were found that may require less emphasis in the current audit.

An auditor can request copies of prior audits through the Department's automated RM-4 Tracking System. Requests go to the Records Management Bureau, which will locate and forward to you the audit file or an explanation of why it cannot complete your request.

## **Researching Taxability**

Through examination of the taxpayer's filing history and other information in the audit file, the auditor will have an idea of the type of business or industry being audited.

The auditor should make use of the following in researching an issue:

- Tax Law and Rules - each office has copies of the tax statutes, DOR written pronouncements and administrative rules which are available through the MASSTAX Legal Guide and DORNET. The auditor should be familiar with the rules governing issues surfacing on audit.
- Audit Division Directives - occasionally, Audit Division directives are issued on legal and procedural issues that require guidance called Legal Advice Memorandum's-LAMs and are available through DORNET and not for external distribution.
- Publications - informational tax guides have been prepared by the Department on various tax areas. The Legal Library on DORNET references Letter Rulings, Technical Information Releases, DOR Directives and Regulations. This reference material can also be found in the MASSTAX Legal Guide. When used, the auditor should ensure that the tax guides are current with the latest tax law.
- Discussions with Supervisor/Manager - if the research has not provided the answer to taxability issues, the auditor should then discuss the issue with the supervisor/manager. If possible, your supervisor/manager should discuss the issue with their legal partner to determine whether he/she has encountered the same issue. The auditor and the supervisor/manager may need to consult the audit manager/director for the answer. If the auditor does not get an answer from these discussions, guidance should be requested from the Bureau Chief upon approval from management.
- Resolution By Bureau Chief - the audit manager/director will only request an answer from the Bureau Chief after all of the aforementioned efforts to resolve a tax issue have been exhausted. Resolution by the Bureau Chief should not be requested at the pre-audit stage, but only after the auditor thoroughly understands the taxpayer's situation, has researched it and still cannot resolve it.

## **Other Sources of Information:**

Depending on the size, complexity, etc., of the taxpayer to be audited, sources of information such as the following may be considered prior to beginning field work.

- Telephone Directory Yellow Pages can be used to identify locations and the types of services provided by the taxpayer as well as phone numbers;
- DTAX Warehouse business information;
- Corporations Division through Secretary of State Website [www.sec.state.ma.us](http://www.sec.state.ma.us) - Can be used to search the Corporate Database to identify business location, year- end status and corporate officer information;
- Company Web Pages and other sources of information are available on the Internet;
- Directory of Corporate Affiliations - Lists parent corporations, their divisions, subsidiaries and even plant locations. This directory gives a quick view of the corporate structure, interests, types of business activity (via SIC codes), sales volumes, contact names and phone numbers; and
- Security and Exchange Commission 10K Reports - Available online or obtained from the taxpayer.
- Occasionally, the prior audit file will include magazine or newspaper articles about the taxpayer's business. These should be read in their entirety for items of interest.

## **Audit Notification**

Telephone contact with the taxpayer should be made prior to issuing the appointment letter in order to facilitate the scheduling of the audit.

The auditor must inform the taxpayer of the Department's intention to conduct a field examination by issuing the following documents sent by first class mail or electronically through secure mail:

- Notice of Audit Appointment Letter
- Checklist/Information Document Request ; and
- A copy of "The Audit Process"

These pre-populated notices are located in Audit WorkBench (AWB)-Notice Generation. A copy of the letter and checklist is retained in the electronic audit case folder through Audit WorkBench (AWB)-History where these notices can be viewed, but not edited to represent an image of exactly what was sent to the taxpayer. Any notices issued using the Audit WorkBench (AWB)-Notice Generation templates will create an automatic case log entry based on the actions performed within the electronic audit case folder.

Note: Manual case log entries must be used to capture the hours for specific actions taken on a case and can be edited, if necessary. Auto case log entries cannot be edited.

If the taxpayer elects to provide the original records required to conduct the audit in the DOR office, a Taxpayer Document Receipt Form must be completed, signed and dated by each party in both instances where the records are received from the taxpayer to the DOR Representative and when the records are returned by the DOR Representative to the taxpayer. This procedure must be documented in the AWB-Case Log.

If telephone contact cannot be made, the auditor must mail the Notice of Appointment Letter, or a Notification of Audit with enclosures, by Certified Mail.

In addition, the auditor should consider and decide whether the issuing of other forms are required at the time of audit notification, such as the Notice of Failure to File a Return for identified delinquent periods, a Form A-37 in order to timely execute an extension of time for assessment due to an imminent expiration period or a Form M-2848 (Power of Attorney).

As part of the auditor's pre-audit research, the auditor should have reviewed the filing status of the taxpayer regarding all tax types for which the taxpayer would be responsible. If upon such review, the auditor finds that a taxpayer is a non-filer for any such tax types, then he/she should issue an NFF along with the Notice of Appointment Letter for any periods where no automated failure to file notices have been issued. The auditor should then check the filing status of each case in their inventory on periodic basis as directed by Bureau Management and if they discover any additional non-filed periods, then a NFF should immediately be issued for periods where no automated failure to file notices have been issued. In addition, such a review must also be performed when preparing the case for final supervisory approval.

Note: It is important for auditors and supervisors to maintain accurate information in Audit WorkBench-Contacts. This information is replicated in Audit WorkBench-Correspondence Generation in the recipient data field. All Audit Forms in Audit WorkBench-Correspondence Generation can be found using the drop down arrow.

## **Telephone Contact**

In contacting the taxpayer via telephone call, the auditor should:

- Identify himself/herself and the purpose of the call;
- Discuss the tax or taxes to be audited;
- Establish an appointment for the opening conference and a date to commence the audit. Verify the taxpayer's location and get directions;
- Tell the taxpayer what records may be required and that additional records may be necessary as the audit proceeds;
- Discuss the availability of records in electronic format;
- Discuss the option of using Computer Assisted Audit Techniques (CAATS) as a tool for conducting the audit;
- Determine the location of the records. If the records are outside of the audit office assignment area, then a transfer of the audit should be considered;

- Inquire about available working space;
- If possible, determine the taxpayer's understanding and interpretation of the laws and rules with emphasis on recent law changes;
- Observe the rules of professional conduct;
- Complete a list of questions to ask the taxpayer during pre-audit research to make the initial contact more professional and efficient for both the auditor and the taxpayer;
- Obtain any other information that may be needed before the opening conference takes place, especially for an audit that requires out-of-state and out-of-town travel; and
- Grant a reasonable request by a taxpayer to delay the audit with supervisory approval. At this time, the taxpayer must consent to sign the Agreement to Extend the Time for Assessment of Taxes, Form A-37 (waiver), otherwise a postponement should not be granted. The auditor should also note in his/her case log the reasons for any delays at the start of or any other time during the audit review. In granting reasonable delays, a letter of confirmation should be issued to the taxpayer. A request by a taxpayer or legal representative for a delay of over 60 days should be made in writing and approved by his/her supervisor before such request is granted.

## Chapter 3

### Audit Planning and Documentation: The Electronic Audit Case Folder

#### Introduction

The Audit WorkBench (AWB)-Case Plan contains the sequence of tasks for the specific audit types and includes a detailed account of tasks performed during the course of the audit. The Case Plan generally includes the following components:

- Research-Pre-Audit Analysis;
- Planning-Opening Conference and Initial Audit Review;
- Examination-Audit Review and Documentation;
- Findings and Reporting-Supervisory Review and Exit Conference Procedures.

#### Record of Audit Planning, Activities and Results

The Case Plan covers a wide scope of audit activities and responsibilities associated with the conduct of a tax examination by audit personnel. The Case Plan's check box structure is designed to enable the auditor to check off tasks upon completion while the audit is in progress and serves as a reference to guide the auditor towards completing the required tasks in preparation of the electronic audit case folder for supervisory approval.

#### Case Plan

The Case Plan is divided into Primary Tasks and Subtasks and captures the required steps which must be performed during the course of an audit. Primary Tasks will auto-check once all associated Subtasks are completed. Subtasks can be completed in random order allowing for the flexibility of workflow, but a Primary task will only auto-check when all prior Primary Tasks are performed.

An auto case log entry will be posted to the electronic audit case folder when all of the Subtasks are completed within the Primary Task.

The electronic Post-it feature allows the auditor to manually enter notes on the Case Plan to alert management to important details or information which may be relevant during the review of the case.

**Case Plans are provided in detail within each tax specific chapter of this manual.**

The following are common components among all case plans; however procedures vary between the field bureaus and tax types.

Differences are noted, especially in the opening and exit conference proceedings; the New England Audit Bureau handles opening conferences with the supervisor, auditor and taxpayer present while discussing the audit parameters and the Multistate Audit Bureau conducts their opening conferences with the auditor and taxpayer present.

Multistate Audit Bureau managers only attend exit conferences if there are unresolved audit issues. If so, the audit work papers and final assessment summary are revised in accordance with the exit conference determinations and sent to the taxpayer.

- **Research:**
  - Pre-audit Analysis and Contact
  - Schedule an opening conference
- **Planning:**
  - Opening Conference
  - Initial Audit Review
- **Examination:**
  - Audit Review
- **Supervisory Review, Case Closing & Exit Conference Procedures.**

## **Case Log**

The Audit WorkBench (AWB)-Case Log is a detailed chronological record of all activities related to the assignment and conduct of the audit. The Case Log is completed on a daily basis to document all interviews, discussions, audit work, records examined, identity of all participating individuals and correspondence either issued or received.

The Case Log should document:

- The source of audit assignment and the criteria used in its selection;
- The opening conference, in particular, the presentation and discussion of the Taxpayer Bill of Rights and how it relates to the audit process and avenues of appeal;
- Any delays in the start of the audit or the completion of the audit;

- All entries should be factual in nature and pertinent to the case. For example, the Case Log should not have entries which state that the Taxpayer cannot tell time and does not know how to organize its information. Instead, for example, the Case Log entry should read that the auditor met with the Taxpayer on xx/xx/xxxx; the Taxpayer was one hour late for the appointment and it was the third appointment in which the Taxpayer showed up late without any records.

There are two types of log entries: manual and automated. All entries record the auditor's name, category, time/date stamp, last update date, hours and location of the action.

Manual Case Log entries are user-created by clicking the Add button where you assign the entry a date, category, hours and location, which are the only way to capture hours dedicated to a specific case. Enter the text and click Save to record the entry. Fixed values of the manual entry are Created By and Date Entered.

Automated Case Log entries are created when certain case actions are taken within the electronic audit case folder and cannot be edited.

The Export feature allows the auditor to send the Case Log to an HTML file for a complete view of all entries and details.

## **Audit Work Papers**

Auditors use standardized Excel spreadsheets for work papers and attach them to the case in Audit WorkBench (AWB)-Attachments.

### **A. Basis and Content of Work Papers**

Audit Work papers are an essential component of an audit. Work papers serve several important functions:

- Provide a historical record showing all the audit work performed;
- Contain the basis for the auditor's conclusions and proposed adjustments, if any; and
- Provide support for audit assessment determination if the taxpayer appeals.

The work performed and the conclusions reached by an auditor must be adequately documented in the audit work papers. Using the standardized Excel templates, worksheets can be easily created from the established template library, and may also include merging taxpayer provided records into the workbook. The content of the work papers should be dictated by the nature of the audit:

- Work paper volume will vary from case to case due to the condition of the financial records, statements, schedules and degree of examination required;

- Work papers should be restricted to matters that are relevant, material and directly related to the audit objectives;
- Each distinct subject should be covered by a separate schedule of the work papers;
- The sample selection and the sample size are determined using data analysis through the statistics function of ACL and Statistical Audit, an approved propriety software developed by our contracted statistician;
- After tests are made and the detail analysis is performed, auditors should record their findings using specific worksheet templates;
- Single-error block projections, multiple-error block projections and statistical sample projections (CAATS) are easily recorded in the templates provided based on the agreed upon method; and
- The auditor may incorporate as part of the work papers any work papers prepared by the taxpayer that are part of the books and records. All examined documents, invoices, vouchers, etc., must be clearly identified and, if included, must be scanned and attached to the electronic audit case folder in Audit WorkBench (AWB)-Attachments.

## **B. Format of Work papers**

Work papers requires certain uniformity to make them useful. Work papers should incorporate the following standards:

- Each standardized worksheet is created from a template workbook which allows the auditor to use only the schedules necessary to record his/her findings based on the tax type and records examined, and is labeled as such on the Worksheet Tab;
- Each work paper in the workbook will be auto populated by its case details in the Filings sheet, including tax type, audit periods, taxpayer ID number, and demographics, auditor information and filing details of the audit period(s);
- Each examination impacting tax is linked to the Audit Summary sheet for supervisor/manager review which can be marked final or revised and the results will then be posted to Audit WorkBench (AWB)-Assessments;
- Each spreadsheet-based work paper must have a descriptive heading, identifying the taxpayer, ID number, AWB or MATIS Case ID number, audit period(s), auditor name and ID, date, page number and title of the work paper;
- Each spreadsheet-based work paper must include proper column headings and cross-references from other schedules or work papers when appropriate;
- Each spreadsheet-based the work paper should be kept in logical groups;
- Upon completing the work papers, the auditor should review his/her work to see that it is accurate; and
- Each spreadsheet-based work paper including supporting documentation must be attached in Audit WorkBench (AWB)-Attachments using suggested filenames and attachment categories for easy identification and review by supervisors/managers.

## **C. Summaries of Work Papers**

Audit work papers created through standardized templates will form an assessment package containing the following information:

- Filings which displays the filing history review of return line-items;
- Penalties which calculates manual penalties on the tax due, when applicable;
- Audit Summary which displays the taxable amounts for each worksheet included in the assessment and calculates the tax on the total;
- Tax Summary which displays total tax from each examination as well as credits from filings and penalties; and
- These total tax figures are posted to Audit Work Bench (AWB)-Assessments and interface with AAHT in MASSTAX to generate the Notice of intention to Assess (NIA).

Audit work papers created using spreadsheets to form the basis of the audit assessment should include the following:

1. Detail transaction listings for each examination;
2. Summary spreadsheets which tie together groups of work papers that relate to a particular audit examination, verification or exercise;
3. Assessment Summary which reflects the total tax due or over assessment figures per audit based on each examination and/or summary spreadsheets; and
4. These figures will be entered into Audit WorkBench (AWB)-Assessments and interfaced with AAHT in MASSTAX to generate the Notice of intention to Assess (NIA).

## **D. Volume of Work Papers**

The volume necessary to efficiently complete the audit and convey its results is dependent on the auditor's judgment and the scope of the audit.

## **E. Work Papers Reviews**

All final work papers should be reviewed by the supervisor or manager before presentation to the taxpayer or taxpayer's representative to ensure that audit opinions are clear and objectively evidenced and that there are no unanswered questions or other loose ends. Whenever possible, the supervisor or manager will review the preliminary work papers. In addition, all preliminary work papers must denote the fact that they are subject to change based on supervisory or managerial review. There may be several versions as the taxpayer produces additional documentation throughout the course of the field work.

- Several points should be considered while conducting a review of the work papers:
  - Was the Case Plan followed?
  - Did the auditor comply with any necessary specific instructions?
  - Do the work papers evidence the work performed and sufficiently support the audit findings?
  - Were the conclusions reached reasonable and valid and supported by statute?
  - Were Audit Division rules on work papers followed?
  - Were the approved standardized templates used?
  - Are there sufficient detail documents to support the auditor's findings on contested issues (e.g., contracts, purchase orders, freight bills, certificates, etc.)?

Well-organized cases and effective instruction by the supervisor can help ensure the inclusion of only relevant documents in the work papers.

## **F. Controls for Work Papers**

The auditor should know exactly where the work papers are at all times during the conduct of the audit to protect the confidentiality of the information.

Upon completion, and after review and approval by the supervisor, one copy of the work paper schedules are given to the taxpayer or taxpayer's representative and the original work papers and subsequent revisions remain in AWB-Attachments as part of the electronic audit case folder.

## **Audit Narrative**

The Audit Narrative should be a reporting of steps covered in the completion of the audit process, including the assignment of the case, the opening conference, the examination of the records, the audit findings including the statutory cites pertaining to the issues surrounding the exceptions listed on the audit work papers and the conclusions based on the best information and belief presented by the taxpayer, the exit conference and the taxpayer's position regarding these findings. The Audit Narrative should be prepared as a word document then added to the electronic audit case folder through Audit WorkBench (AWB)-Attachments.

The following audit activity should be included in the audit narrative:

- Source/Basis of Audit Assignment-the auditor should state the reason for the case assignment such a generic and specific source of audit code, if applicable.
- Overview of Taxpayer-the auditor should include information about the taxpayer such as:

- The taxpayer's type of business such as contractor, manufacturer or retailer just to name a few and the exemptions that the taxpayer may or may not be entitled to as a result of their status;
  - Information as to whether the taxpayer is classified as a manufacturing corporation;
  - Type of ownership such as corporation, partnership, sole proprietorship or Massachusetts Business Trust;
  - The business locations in MA or facilities out-of-state, the date the business began in MA and the number of employees;
  - Applicable tax registrations along with the filing history including outstanding-filer periods (O/F), None Returns or Use Tax reported;
  - The name of the contact person(s) including title, phone number and e-mail address, outside representation, if any;
  - List whether a Form M-2848 (POA) was obtained;
  - The taxpayer's bank and account number and responsible person (transaction tax cases, excluding Multistate);
  - If any of the following notices are issued to the taxpayer then document as such: Notice of Failure to File Returns (NFF), Notice of Failure to Register and File Returns (NFR) or Notice of Incorrect/Insufficient Return (NIR);
  - List whether Form A-37(waiver) was executed;
  - The prior audit history should be reviewed, if any, including the prior completed case folder discussing any potential audit issues that should be addressed; and
  - The related taxpayers, tax types and Case ID number should be referred to in this section.
- Records Examined-the auditor should review and include the tax specific records examined during the audit as well as the records common to all cases such as:
    - Prior completed case folder; and
    - Federal and MA Corporate Excise tax returns.
- Detail Summary of Audit-the auditor should list the areas examined and the exposure or the result of the examination, if any:
    - Each examination finding should include the sample periods, if any, and how the sample size was selected as well as whether or not a Notification of Sampling and Representative Test Agreement was issued and signed by the taxpayer and/or taxpayer's representative (transaction tax cases only);
    - Each examination should include, in general, the type of items found subject to tax and why, but the auditor may want to include specific references to certain issues and were any items listed based on Letter Rulings, DOR Directives, Technical Information Releases or, Regulations; and

- Each examination should include the taxable totals with a breakdown of tax attributed to each audit issue or adjustment and the last paragraph of the summary should list the overall tax deficiency/over assessment.
- Federal/Mass Audit History-the auditor should include whether or not the taxpayer was previously audited by DOR referencing the audit period and case number as well as whether the case went to the Office of Appeals (OOA), filed a CA-6, case pending litigation including the docket number or whether or not any federal audits were disclosed during the audit time frame. Whenever applicable, the auditor should identify the status of the latest IRS audit (RAR), the date finalized and note the date the last federal changes were reported.
- Taxpayer's Position and Auditor's Recommendation-the auditor should explain the conclusion of the audit:
  - Does the taxpayer and/or the taxpayer's representative agree with the audit findings, if not, include which specific issue(s) or adjustment(s) will be appealed and why;
  - Did the taxpayer and/or the taxpayer's representative state whether or not they would request a pre-assessment conference and/or settlement consideration;
  - Does the taxpayer wish to receive a Notice of Intention to Assess (NIA) or will they file Amended Returns (CA-6);
  - Did the taxpayer state whether or not they would implement systems to properly track and report tax in areas where they were deficient? Does the auditor think the taxpayer will do a better job; and
  - Does the auditor recommend another audit for subsequent periods? If so, please provide an explanation as to why.

## Chapter 4

### Opening Conference

#### Introduction

The opening conference is a meeting between the auditor and the taxpayer or taxpayer's designated representative, prior to beginning the examination of the taxpayer's books and records. This conference is generally the first face-to-face meeting between the taxpayer or representative and the auditor.

Supervisors from the New England Audit Bureau should be in attendance at most opening conferences. If the supervisor is unable to attend, the auditor should inform the taxpayer of their supervisor's name, telephone number and electronic mail (e-mail) address should questions arise that the auditor is unable to address.

Audit Managers from the Multistate Audit Bureau typically do not attend opening conferences due to time constraints, travel requirements and office logistics. Again, auditors should inform the taxpayer of the audit manager's name, telephone number and e-mail address should the taxpayer have questions.

The opening conference is the foundation of a good audit and generally sets the tone of the auditor's dealings with the taxpayer. The taxpayer should be left with the impression that the auditor will be honest and fair, flexible and interested in serving the taxpayer, and willing to educate and assist the taxpayer. The auditor must ensure that all taxpayer records are kept confidential and DOR equipment is maintained in a secure environment at the audit site. In addition, all e-mail communication should be sent through secure mail.

During the opening conference, the auditor should make the taxpayer aware of the purpose of the audit and what is expected of the taxpayer as well as what the taxpayer may expect of the auditor.

#### Topics to Discuss at Opening Conference

Upon arrival at the taxpayer's place of business, the auditor should properly introduce himself or herself providing proper identification if requested. Then the auditor should hold a preliminary discussion with the taxpayer about the business and the audit and address any questions that were not covered during telephone contact, including the following:

- The scope and objectives of the audit;
- A discussion of the Taxpayer Bill of Rights, with an emphasis on the audit process and appeal rights, including pre-assessment conferences and settlement consideration with the Office of Appeals (OOA);
- Availability and location of records to be examined referencing the

checklist/Information Document Request Form which was sent along with the Notice of Audit Appointment Letter;

- Records that are unavailable should be discussed to determine the cause and documented in the Audit WorkBench(AWB)-Case Log;
- Discuss and document the need to secure an executed Agreement to Extend the Time for the Assessment of Taxes, Form A-37(waiver) especially if the taxpayer cannot provide documentation in a timely fashion;
- Discuss the allowance of a reduction in interest rate if the length of a field audit exceeds 18 months and is measured from the length of time from the opening conference date and the NIA date;
- What audit procedures may be used;
- Verify historical information with the taxpayer and perform necessary file maintenance;
- Update information obtained through pre-audit research and/or the necessity of any required file maintenance (CRC's, applications, etc.) to be completed;
- Explain that any DOR enforcement action in process will continue even though an audit is in progress. The auditor should always have the taxpayer file any delinquent returns that are due; and
- Request a tour of the facilities to understand the taxpayer's business, products, possible manufacturing exemptions and utilization of assets.

All opening conference activities must be documented in the Audit WorkBench (AWB)-Case Log.

Note: Opening Conference procedures are discussed in detail within each tax specific chapter of this manual.

### **Interest Charges after Audit**

Administrative provisions within the Fiscal Year 2012 Budget, "The Acts", allows for a reduction in interest charges if the length of a field audit for certain tax periods filed by a taxpayer exceeds 18 months and results in a deficiency assessment issued by the Department of Revenue (DOR). The length of audit is measured from the opening conference date to the date the Notice of Intention to Assess (NIA). The new interest calculation in accordance with G.L. c. 62C, § 32(f) will apply to interest accruing on deficiency assessments where the audit resulting in the deficiency assessment is commenced after July 1, 2011.

The Notice of Audit Appointment incorporates the new language regarding G.L. c. 62C, § 32(f) in which the date of the audit appointment will serve as the opening conference date. A waiver form was developed for use in conjunction with G.L. c. 62C, § 32(f). Form A-32, Consent to Waiver or Toll the Time Period Under Chapter 62C, section 32(f), has been approved with both Option 1 and Option 2 available for the taxpayer's selection. By selecting Option 1, a taxpayer is foregoing any right to a reduced rate of interest under c. 62C, § 32(f). By selecting Option 2, the taxpayer agrees to extend the 18 and 36 month periods in § 32(f) by an agreed upon set period of time (i.e. an

additional 2 or 3 months). Option 2 can be subsequently extended by executing another agreement.

If applicable, § 32(f) reduces the interest rate by 2 percentage points, not to go below zero, for NIA's with issue dates that fall between 18 months and 36 months after the opening conference date. The reduced interest rate only applies interest charges accruing after the 18 month period. There is no interest rate reduction to any interest charges accruing prior to the 18 month period. If the NIA issue date exceeds 36 months from the opening conference date, the interest rate may be reduced by 2.5 percentage points not to go below zero. The 2.5% reduction only applies to the interest accruing after the 36 month period under § 32(f). For the reduced interest rate to apply, DOR must determine that the taxpayer complied with all requests for information or documentation made during the audit period with substantial promptness and completeness, and the taxpayer was not otherwise responsible for the extended duration of the audit. A taxpayer may appeal the Department's determination that the taxpayer did not comply with an audit request for information or documentation with substantial promptness and completeness to the Appellate Tax Board along with any assessed tax in dispute. For further information, please see Technical Information Release (TIR 11-6) regarding this issue.

The following examples demonstrate the use of Form A-32.

- A large multinational company with many state audits being conducted simultaneously mentions up front that it is going to have difficulty meeting record requests within certain time frames. Rather than being held to rigid time lines to ensure that the audit is completed within 8 months of the opening conference, the taxpayer opts to waive its right to a reduced interest rate to allow additional time to respond to information requests. In this situation, the DOR and the taxpayer may agree to waive G.L. c. 62C, § 32(f).
- In some instances, the taxpayer may not wish to waive its entire right to an interest reduction under G.L. c. 62C, § 32(f). Although the taxpayer may not wish to waive its rights under G.L. c. 62C, § 32(f), it may not be able to comply with substantial promptness and completeness to a particular request. For example, a taxpayer installs a new accounting software system and has to devote substantial efforts to the implementation of the new system. During implementation, the taxpayer will not be able to respond to information requests in a timely fashion. In this situation, the DOR and the taxpayer may agree to toll G.L. c. 62C, § 32(f) for a set period, such as an additional 3 month time period. If an additional 3 month waiver is signed the reduced interest rate will not be applicable until the 21st month or 39th month as the case may be.

While the DOR and the taxpayer might agree to waive or toll G.L. c. 62C, § 32(f), the field audit staff, including the auditor, supervisor and/or manager, must do their best to ensure the audit progresses in the most efficient manner. The signing of Form A-32 does not excuse the auditor from timely case completion. As with other extensions of

the statute, the supervisors and managers must be informed prior to securing Form A-32.

In addition, the securing of a Form A-32 does not relieve the auditor from monitoring and protecting the statute of limitations under G.L. c. 62C, §26. To protect the statute under §26 the Department and the Taxpayer can agree to extend the statute of limitations under §27 by executing a Consent Extending the Time for Assessment of Taxes. (See Form A-37 or B-37). Please refer to Chapter 1 of this manual for more information.

### **NonFiler Inquiry and Procedure**

During the conduct of the audit, the auditor must determine and resolve whether the taxpayer has failed to file a return, report of federal change or register with the Department for any tax for which it has a filing requirement.

The auditor must also consider and decide if a return is required to be filed by any out-of-state third party engaged in activities or transactions with the taxpayer. Upon determining that an activity or transaction may require the filing of a return with the Department, the auditor should discuss the matter with his/her supervisor who will either refer the matter to the Bureau of Desk Audit, Voluntary Disclosure/Nexus Unit, for issuance of the requisite nexus questionnaire or instruct the auditor to issue the nexus questionnaire if the non-filing taxpayer is located within the regional office's audit territory.

If it is determined that a taxpayer has failed to file a report of federal change to income, the auditor should incorporate the federal change into the audit deficiency rather than referring it to the Bureau of Desk Audit. The auditor should instruct the taxpayer to file Form CA-6 (Application for Abatement/Amended Return) to report any change to income for any years not currently under audit.

The auditor or supervisor/manager should send an e-mail to the Federal Change Unit, Bureau of Desk Audit, to state that the federal change will be incorporated into the field audit. The auditor should enter a taxpayer "note" in the MASSTAX system with the same information including the tax years involved.

**The Notice of Failure to File a Return** (Form NFF/WebFile) and the **Notice of Failure to Register and File a Return** (Form NFR/WebFile) should be mailed to a taxpayer failing to comply with Massachusetts statutory filing requirements. The taxpayer must be allowed 30 days to comply before initiating assessment action.

The Notice of Failure to File a Return (Form NFF/WebFile). The Notice of Failure to Register and File Return (Form NFR/WebFile).

The auditor should inform the taxpayer that new business or individual tax registrations must be completed through WebFile for Business (WFB). WebFile for Business (WFB),

the DOR's web-based application, allows the taxpayer access to file and pay certain tax obligations. Additional information is provided in A Guide to WebFile for Business located on-line at **[www.mass.gov/dor](http://www.mass.gov/dor)**.

### **Incorrect or Insufficient Return**

If, during the course of an audit, an auditor has reason to believe that a taxpayer has filed an incorrect or insufficient return based on a pattern of mis-reporting, he/she must discuss this matter with his/her supervisor and receive approval from the Director or Manager prior to issuing a Notice of Incorrect or Insufficient Return (Form NIR). The taxpayer has 30 days from the date of the notice to demonstrate the correctness of the original return or to file an amended return through WebFile for Business using Form CA-6 (Application for Abatement/Amended Return).

If taxpayer files an amended return in response to the notice, the auditor will determine the reasonableness of the return and decide if audit activity is warranted. The returns can be viewed through WebFile for Business and no longer require processing by the auditor.

If the taxpayer fails to respond to the notice within the time allowed, the auditor will complete the audit and initiate assessment action as provided under MGL, Chapter 62C, section 28. See the Notice of Incorrect or Insufficient Return (Form NIR).

## Chapter 5

# Audit Completion: Documentation of Findings and Administrative Remedies

### Introduction

Upon completion of the audit process and discussion of the audit results, the auditor and his/her supervisor or manager will confer with the taxpayer and/or designated representative at an exit conference. The auditor will prepare the electronic audit case folder to submit to his/her supervisor or manager for review including any audit adjustments prior to the exit conference. The conference is used to:

- Inform the taxpayer of audit results.
- Educate the taxpayer as to proper procedures to follow in the future.
- Explain the taxpayer's rights and available administrative remedies.
- Inform the taxpayer of penalty, interest and billing procedures.

### Discussing the Audit

The discussion of the audit will include:

- Any adjustments made are noted in accordance with the applicable laws or rulings involved. If not already given, then at this time copies of rulings and work papers that support the audit adjustments should be given to the taxpayer.
- The records used or examined and audit method employed. The reason for employing these methods will also be discussed.
- The mechanics of the audit, the basis of the audit assessment and how the assessment will be reflected on the proposed Notice of Intention to Assess (NIA). Included are any calculations, projections or other information detailed on the auditor's schedules. If not done already, then at this time the taxpayer will be given copies of all final audit schedules.

### Discussing Future Compliance

Promoting future tax compliance is one of the main goals of the Department of Revenue.

During an audit, the auditor has an opportunity and responsibility to help educate the taxpayer. The auditor can make recommendations on proper tax reporting methods; however, the auditor must not attempt to set up or redesign the taxpayer's accounting system.

The taxpayer should be aware that the tax law changes may impact business operations and that it is the taxpayer's responsibility to keep up-to-date with these changes. The Department publishes informational tax guides for mailings, provides taxpayer assistance on the proper tax treatment of specific transactions and maintains an updated legal library, which includes tax law changes, current rulings and regulations, technical information releases and directives that can be found at [www.mass.gov/dor](http://www.mass.gov/dor).

### **Audit Deficiency**

The taxpayer should be made aware that interest continues to accrue on any unpaid portion of a tax deficiency while administrative remedies are pursued.

### **Taxpayers Who Cannot Pay**

Auditors should advise taxpayers who cannot pay to discuss payment options with a representative from the Collections Bureau. Payment plans are outside the scope of the Audit Division and handled within the Taxpayer Service Division.

### **Collections Problems**

If the auditor believes that state funds are in jeopardy due to insolvency, a jeopardy assessment can be requested instead of a regular deficiency assessment. A jeopardy assessment will allow immediate notice and demand for payment rather than 30 days after the Notice of Intention to Assess. Approval by Directors and Chief of Bureau is needed for a jeopardy assessment to be issued. The auditor/examiner seeks approval through Audit WorkBench (AWB) by accessing Case Approvals and requesting Jeopardy Approval. Once final approval is granted, the case supervisor will access Interface Details to "Validate" and "Interface" the case which will issue the Jeopardy Assessment.

### **Credit Audits**

If at the end of an audit, there is an overall credit, the taxpayer will receive a refund.

The auditor will advise the taxpayer that:

- A refund will not be issued until all outstanding liabilities with the agency are satisfied.
- The total refund may be less than estimated if deficiencies occur for some other audit period in the audit.

The refund may be offset by penalties and interest associated with these deficiencies.

## **Penalty Waiver Procedures**

(Revised Apr-09)

### **Summary**

Massachusetts General Laws provides for the imposition of penalties for the failure to comply with the tax laws of Massachusetts. They also permit the Commissioner of Revenue to waive or abate penalties in certain circumstances. The Audit Division is authorized to make penalty waiver determinations.

### **Imposition of Penalties, Generally**

M.G.L. Chapter 62C, Section 33(a)-(c); (g) (Late File and Late Payment)

M.G.L. Chapter 62C, Section 28 (Double Assessment)

M.G.L. Chapter 62C, Section 34 (Information Returns-Partnerships)

M.G.L. Chapter 62C, Section 35 (Protested Checks); Sections 35A - 35E (failure to disclose; pay)

### **Authority to Waive Penalties**

M.G.L. Chapter 62C, Section 33(f)

Administrative Procedure 633 (AP633)

### **Background**

Penalties may be waived if the taxpayer can support the contention that noncompliance was due to reasonable cause and not willful neglect.

Determinations are based on particular facts and circumstances of each case.

Criteria detailed in the Official Commonwealth of Massachusetts, Department of Revenue, Masstax Guide, Administrative Guide, AP633 should be reviewed, conveyed to the taxpayer and used as a guide for determining an approval or denial of waiver of penalty requests.

Penalties may be abated only in circumstances where the taxpayer files returns through WFB/E-file during the course of the audit and submits a penalty waiver request. In these circumstances, the returns will post before the penalty waiver requested is acted upon thus creating an abatement situation. It is more efficient for the Audit Division to act on any penalty forgiveness in such cases where the auditor/examiner is most familiar with taxpayer arguments and situations.

## Forms

Waiver of Penalty Request Form

Delegation of Authority:

AP 633 no longer requires that two levels of DOR personnel must review every waiver request. Therefore, the decision to waive or apply the above penalties will be made by a single decision maker in accordance with the following delegation of authority table(s):

### **Audit Personnel Recommendation Approval**

Auditor/Examiner/Supervisor/Manager	All Waivers
Director	\$100,000.00 or less
Bureau Chief	\$250,000.00 or less
Associate Deputy Commissioner	\$500,000.00 or less
Deputy Commissioner	\$500,000.00 or less
Senior Deputy Commissioner	\$1,000,000.00 or less
Commissioner	\$1,000,001.00 or more

### **Penalty Waiver Processing Procedures**

In general, Directors and Senior Managers within the chain of command will make the decision to waive or apply penalties up to their respective levels of authority.

All penalty waiver requests will be handled through Audit WorkBench (AWB). The auditor/examiner will enter the penalty waiver request amounts and make his or her recommendation. The penalty waiver request form, all correspondence including the taxpayer's penalty waiver request letter, and supporting documentation should be scanned and attached to the case and placed in the "All Administrative Forms" category. The request will be routed to the Regional/Unit Director for the initial approval or denial of penalties. All penalty waiver requests will be routed to the appropriate senior manager, as discussed below, when the request is greater than the Director's level of authority.

## **AWB - Case Attributes**

AWB Penalty Waiver screen prints

### **Taxpayer Responsibilities**

- Submits a written request seeking penalties to be waived to auditor. The letter must include a statement of fact supporting the contention that the noncompliance was due to reasonable cause and not willful neglect. The letter must be signed and dated by the taxpayer and/or a duly authorized representative.

### **Auditor/Examiner Responsibilities**

- Advises taxpayer of the administrative remedy, AP633, Penalty Waiver process.
- Reviews taxpayer's written penalty waiver request and any supporting documentation including taxpayer's filing history.
- Scans and attaches the taxpayer's penalty waiver request and any supporting documentation to the case and places in the "All Administrative Forms" category.
- Reviews AP633 for determination guidance.
- Determines recommendation, including impact of any penalties that may be applicable on an NIA to be issued subsequent to delinquent returns.
- Completes penalty waiver request form and attaches the form to the case and places in the "All Administrative Forms" category.
- Enters penalty waiver amount requested and reasonable cause category, which best supports the taxpayer's position.
- If necessary, includes additional comments, including multiple penalty waiver factors, to support the recommendation in the Attachments node and places in the "All Administrative Forms" category.
- Navigates to select Penalty Waiver Approval or Penalty Waiver Denial and saves.
- Upon saving the request, AWB will route the request to the Regional/Unit Director for approval or denial.

The supporting documentation scanned and attached to the AWB case should include the taxpayer's letter explaining the reason(s) that led to the delinquencies. This attachment should be placed in the "All Administrative Forms" category.

Case processing responsibilities upon approval/denial of a penalty waiver request:

- Advises taxpayer of DOR's determination via letter which is prepared by the appropriate audit personnel. If the request is denied, the taxpayer

should be referred to the DOR website for the on-line Application for Abatement (CA-6) process. (Currently, on-line applications are only available for the following tax types: 0137 - Sales/Use, 0138 - Sales Tax on Meals, 0143 - Room Occupancy, 0166 - Withholding and 0140 - Individual Income Tax.)

- Please note that an automated selection report will be generated to individuals keying MASSTAX adjustments if an approval is processed.
- Forwards via an M-3210 Transmittal Form, any paper delinquent and/or amended tax return(s) to the DIB for posting of return.
- Enters appropriate note on MASSTAX regarding receipt of penalty waiver and determination.
- Final Approval of any case should not be requested before you:
- Review the taxpayer account on MASSTAX to ensure reasonable cause (890) transaction posted, and
- Review the case to verify that the MASSTAX Representative has set the "**MASSTAX Adjustment**" field to **Yes**.

**Field Audit Personnel should not check-out their case until the MASSTAX Adjustment = Yes.**

Note: If a penalty waiver is approved for NIA purposes only and we do not wish the 890 to post to the period(s) and waive the penalties for the original late filed return, then an email should be sent to the MASSTAX Representative to alert the representative to this fact. An accounting adjustment (775) transaction should be entered in the period(s) in these situations only.

### **Supervisor Responsibilities**

- Final Approval request by your staff or Closure of any case should **not** occur until you:
- Review the taxpayer account on MASSTAX to ensure reasonable cause (890) transaction posted, and
- Review the case to verify that the MASSTAX Representative has set the "**MASSTAX Adjustment**" field to **Yes**.

### **Regional/Unit Director Responsibilities (\$100,000 or less)**

Upon receipt of penalty waiver request for review:

- Reviews the taxpayer's letter, supporting documentation and the auditor's recommendation.
- Determines if penalty should be waived or applied.
- If Director changes the reasonable cause determination or denies the penalty waiver request, a statement should be supplied now to clarify why the reviewer made this determination. Additional comments to support the

determination should be included and placed in the "All Administrative Forms" category.

- Director or his/her designee enters Penalty Waiver Approved Amount or Penalty Waiver Denied Amount and saves.
- Navigates to Approve or Reject the recommendation made by the auditor, enters a note for the approval/rejection and saves.
- "Approved" penalty waiver generates a report for the MASSTAX Representative to post 890's. (Penalty Waiver denials are not processed on MASSTAX).
- AWB - Messages alerts auditor/examiner that the penalty waiver request has been acted upon and receives an "Approval Approved" or "Approval Denied" message.
- Upon receiving "Approval Approved" message, auditor/examiner completes required case processing responsibilities.
- Upon receiving "Approval Denied" message, auditor/examiner should review instructions, make appropriate changes and resubmit Approval request.

### **Bureau Chief Responsibilities (\$250,000 or less)**

Upon receipt of penalty waiver request for review:

- Reviews the taxpayer's letter, supporting documentation and the auditor's recommendation.
- Determines if penalty should be waived or applied.
- If Chief changes the reasonable cause determination or denies the penalty waiver request, a statement should be supplied now to clarify why the reviewer made this determination. Additional comments to support the determination should be included and placed in the "All Administrative Forms" category.
- Chief or his/her designee enters Penalty Waiver Approved Amount or Penalty Waiver Denied Amount and saves.
- Navigates to Approve or Reject the recommendation made by the auditor, enters a note for the approval/rejection and saves.
- "Approved" penalty waiver generates a report for the MASSTAX Representative to post 890's. (Penalty Waiver denials are not processed on MASSTAX).
- AWB - Messages alerts auditor/examiner that the penalty waiver request has been acted upon and receives an "Approval Approved" or "Approval Denied" message.
- Upon receiving "Approval Approved" message, auditor/examiner completes required case processing responsibilities.

## **Audit Executive Responsibilities**

### **Associate or Deputy Commissioner Responsibilities (same level of authority with \$500,000 or less)**

Upon receipt of penalty waiver request for review:

- Reviews the taxpayer's letter, supporting documentation and the auditor's recommendation.
- Determines if penalty should be waived or applied.
- If Associate or Deputy Commissioner changes the reasonable cause determination or denies the penalty waiver request, a statement should be supplied now to clarify why the reviewer made this determination. Additional comments to support the determination should be included and placed in the "All Administrative Forms" category.
- Associate or Deputy Commissioner or his designee enters Penalty Waiver Approved Amount or Penalty Waiver Denied Amount and saves.
- Navigates to Approve or Reject the recommendation made by the auditor, enters a note for the approval/rejection and saves.
- "Approved" penalty waiver generates a report for the MASSTAX Representative to post 890's. (Penalty Waiver denials are not processed on MASSTAX).
- AWB - Messages alerts auditor/examiner that the penalty waiver request has been acted upon and receives an "Approval Approved" or "Approval Denied" message.
- Upon receiving "Approval Approved" message, auditor/examiner completes required case processing responsibilities.
- Upon receiving "Approval Denied" message, auditor/examiner should review instructions, make appropriate changes and resubmit Approval request.

Cases \$500,000 and greater:

- Reviews the taxpayer's letter, supporting documentation and the auditor's recommendation.
- Adds recommendation notes.
- Forwards to Senior Deputy Commissioner and/or Commissioner via e-mail.

## **Commissioner's Office**

### **Senior Deputy Commissioner/Commissioner Responsibilities**

- Reviews the taxpayer's letter, supporting documentation and the auditor's recommendation via e-mail.
- Determines if penalty should be waived or applied.
- Sends e-mail to Deputy Commissioner with determination.

- Deputy Commissioner forwards the Commissioner's Office determination to Bureau Chief.
- Chief or his/her designee enters Penalty Waiver Approved Amount or Penalty Waiver Denied Amount and saves.
- Navigates to Approve or Reject the recommendation made by the auditor, enters a note for the approval/rejection and saves.
- "Approved" penalty waiver generates a report for the MASSTAX Representative to post 890's. (Penalty Waiver denials are not processed on MASSTAX).
- AWB - Messages alerts auditor/examiner that the penalty waiver request has been acted upon and receives an "Approval Approved" or "Approval Denied" message.
- Upon receiving "Approval Approved" message, auditor/examiner completes required case processing responsibilities.
- Upon receiving "Approval Denied" message, auditor/examiner should review instructions, make appropriate changes and resubmit Approval request.

### **MASSTAX Representative Responsibilities**

- Generates report for approved penalty waiver cases.
- Keys 890 transactions in MASSTAX for approved period(s).
- Enters Audit WorkBench AWB-Case Log stating the 890 transactions were keyed to MASSTAX for the approved period(s).
- Navigates to the PW MASSTAX Adjustment field in AWB-Case Attributes and select Yes" from the drop down menu.

### **Exit Conference**

Efforts are made to resolve any and all issues at the exit conference by the auditor's supervisor and/or manager. The taxpayer should be informed about the issues in dispute and that a Notice of Intention to Assess (NIA) will be issued in the near future.

Note: An exit conference does not constitute a hearing per MGL Chapter 62C, section 26(b).

The exit conference procedures differ between the field audit bureaus within the Audit Division. Differences between the geography of the tax base, audit staff and the costs associated with travel both financial and time wise necessitate varying procedures.

### **New England Audit Bureau**

Within ten days from the date of the Exit Conference, if no additional documentation is requested, the audit supervisor and/or manager will provide the

taxpayer with an Exit Conference Letter. If additional documentation is needed, the taxpayer will be requested to provide such documentation within a reasonable time frame. Within ten days upon receiving the additional documentation, the audit supervisor and/or manager will provide the taxpayer with an Exit Conference Letter. The Exit Conference Letter outlines the proposed audit adjustments and the taxpayer's appeal rights. It must also state that any requests for a pre-assessment conference and/or settlement consideration must be sent directly to the Audit Division within thirty days from the issuance of the NIA in accordance with AP 628.3.1. Included with the Exit Conference Letter will be the following Office of Appeals (OOA or Appeals) forms:

- Form DR-1, and
- Form B-37,

### **Multistate Audit Bureau**

Taxpayers are offered an exit conference initially by the audit manager through the issuance of the "10-day Letter". The "10-day Letter" is accompanied with the audit work papers which summarizes the audit issues and identifies the reasons for the audit adjustments. The exit conference can be conducted in person or via the telephone. Once the 10-day period has expired, an "Exit Conference Letter" is issued if there is a change due to an exit conference, additional information or the findings are sustained. The letter explains DOR's position as well as stating the NIA will be issued accordingly.

When additional information is not provided or conference held, the audit manager issues an "NIA Letter" advising the taxpayer that the NIA is being released.

Both the Exit Conference Letter and the NIA Letter will include the taxpayer's appeal rights. The letters must also state that any requests for a pre-assessment conference and/or settlement consideration must be sent directly to the Audit Division within thirty days from the issuance of the NIA in accordance with AP 628.3.1 and must include the above referenced forms DR-1 & B-37.

### **Documentation of The Audit Findings**

Completion of the audit process consists of compiling and documenting the information gathered during the audit and making any audit adjustments resulting from the exit conference. The electronic audit case folder should provide an audit trail that is easily understood by third party users such as attorneys, hearing officers and any others who may rely upon the audit in the future.

### **Audit Review**

The electronic audit case folder is a detailed record of the audit and contains reports, forms, schedules, documents and correspondence relating to the examination and results of a particular taxpayer.

All reports, forms, schedules, documents and correspondence detailing the audit scope and examination findings will be found in the electronic audit case folder. Navigating through Audit WorkBench (AWB)-Case Log, History and Attachments will provide access to all of the relevant case documentation and audit work papers.

Supervisory/management personnel are responsible for reviewing the completed electronic audit case folder in Audit WorkBench and approving auditor findings and conclusions through Audit WorkBench (AWB)-My Approvals prior to issuing a formal notice to the taxpayer. Any audit assessments resulting from the audit of the taxpayer's records will be entered into Audit WorkBench (AWB)-Assessments and will be interfaced with AAHT in the MASSTAX Declaration System which will generate the notice to the taxpayer.

The reviewer's responsibilities include:

- Surveying the electronic audit case folder for additional audit inquiry;
- Reading the auditor's report and understanding all audit findings and conclusions;
- Determining the proper application of statutes, regulations, policies and procedures by the auditor;
- Verifying the accuracy of arithmetic computations;
- Adhering to Audit/NIA approval procedures and securing authorization through Audit WorkBench (AWB)-Approvals for audit finalization in accordance with Audit Division guidelines;
- Ensuring that taxpayer notification procedures and processing of internal documents are timely initiated and completed in order to validate all aspects of the audit.

### **Internal Document Processing**

If, during the course of the audit, an auditor obtains delinquent/amended returns, tax payments, Taxpayer Registration Form TA-1 or any other taxpayer record, the original documents must be date stamped and submitted in a timely manner to his/her supervisor or designee for processing. Copies of the original documents and transmittal forms are to be attached in the electronic audit case folder for supervisory information and review.

Note: Taxpayers should be utilizing the WebFile for Business (WFB) application to register for new tax types, additional tax types, file tax returns, make tax payments and make changes to any registration information online at [www.mass.gov/dor](http://www.mass.gov/dor).

Note: Checks should not be date stamped per bank requirements as of December 2003.

## **Taxpayer Notification**

The tax entered in the Audit WorkBench (AWB) will interface with AAHT in MASSTAX following review, approval and release by a supervisor, manager and/or director and be utilized to notify taxpayers of audit findings through the issuance of a Notice of Intention to Assess (NIA). (Auditors should refer to the Audit WorkBench Manual for the procedures to be utilized within AWB so the NIA will be generated and issued through the MASSTAX system.) Notice to taxpayers involving audits that result in a no change determination is to be given through the issuance of a No-Change Letter, which is found in Audit WorkBench-Notice Generation.

## **Contested Audits**

If a taxpayer disagrees with the audit results, the auditor should be certain that the taxpayer's objections and disagreements are understood and documented in the audit narrative attached to the case and recorded in the Audit WorkBench-Case Log. It is the responsibility of the auditor and/or supervisor to inform the taxpayers of the Office of Appeals (OOA or Appeals) process at the opening conference. Information pertaining to the process should be included in the audit contact letter and/or explained to the taxpayer at the opening conference. The Audit WorkBench (AWB)-Case Log should include an entry to indicate how/when the OOA procedures were explained to the taxpayer.

The three main reasons for disagreement are:

- Application of tax law;
- Audit procedures and methods; and
- The non-availability of records or documents.

A number of disagreed audits can be resolved before entering the appeal process.

- Disagreements concerning applications of tax law are generally harder to resolve prior to appeal because auditors have based decisions on available research. The decisions are not likely to be changed prior to the appeal process since an auditor's supervisor and/or manager are limited to the same research material.
- Disagreements concerning audit procedures may be handled in the exit conference. These disagreements may be due to a lack of taxpayer input during the conduct of the audit or a lack of information shared with the taxpayer or the auditor. Through discussion at exit conferences, a better understanding of why certain audit procedures were used or why the audit procedures require modification may result.
- Disagreements concerning additional records or documentation are handled almost entirely through pre-appeal procedures. During the exit conference, the taxpayer is given time to produce additional information.

After the case has been reviewed and approved by the required supervisor/manager, the Exit Conference Letter will be sent to the taxpayer with Forms DR-1 and B-37 and the Notice of Intention to Assess (NIA) will be issued.

## **Appeal Procedures**

(Revised Nov-10)

Following are the Audit guidelines to be applied when a taxpayer elects to appeal a proposed assessment.

### **1. During the Audit**

During the course of every audit, the Audit Division will ensure that taxpayers are aware of their rights to dispute matters before the Office of Appeals (OOA) prior to assessment.

#### **Opening Conference and/or Audit Contact Letter**

It is the responsibility of the auditor and/or supervisor to inform taxpayers of the appeal process at the opening conference. Information pertaining to the appeal process should be included in the audit contact letter and/or explained to the taxpayer at the opening conference. The audit log should include an entry to indicate how/when the OOA procedures were explained to the taxpayer.

#### **Desk Audits**

If correspondence is initiated prior to the issuance of a Notice of Intention to Assess (NIA), the Audit Process Notification Form, which includes information pertaining to the appeal process, should be sent to the taxpayer.

#### **Exit Conference**

When an exit conference is held the taxpayer should be informed about the issues in dispute and that an NIA will be issued in the near future. After holding an exit conference, the Audit Division will issue an exit conference letter to the Taxpayer outlining the proposed audit adjustments and the Taxpayer's appeal rights. Included with every letter are a Form DR-1 and Form B-37 in accordance with **AP 628.3.1**. The exit conference letter should also clearly state that any request for a conference or settlement must be in writing and should be sent directly to the Audit Division.

## **Request for Conference or Settlement with OOA**

The taxpayer should be instructed to mail appeal request forms to the appropriate recipient in the Audit Division. **To ensure the request is timely**, it must be received within 30 days or postmarked within 25 days of the issuance of the Notice of Intention to Assess (NIA). See 830 CMR 62C.26.1(6)(d)2. The taxpayer may also be asked or instructed to submit the required documents by electronic means such as fax or e-mail with the appropriate scanned items.

If the taxpayer seeks additional time to review the NIA or attempt to resolve it at the Audit level and wishes to preserve its pre-assessment right to appeal it must, nonetheless, make a timely request for a conference/settlement. In such instances, an abbreviated written statement to that effect will be sufficient to preserve its timely appeal rights for up to an additional 30 days, subject to the approval of the Audit Bureau Chief or designee. If approved, the Audit Bureau Chief or designee must inform the OOA Director or designee within 3 business days of such request. If the taxpayer decides to proceed with its request to receive a pre-assessment conference or settlement, a completed request (i.e., Forms DR-1 and B-37) should be submitted no later than the 60<sup>th</sup> day following the date of the NIA. If the taxpayer decides not to proceed with its request to receive a pre-assessment conference or settlement, a written statement should be submitted withdrawing the request. Please note: The NIA should only be revised if adjustment is clearly warranted and the matter will not proceed to OOA for pre-assessment consideration.

## **Submission and Notification of New Appeals**

Taxpayers are instructed to submit their request for appeals directly to the Audit Division. However, OOA will, within one (1) business day, inform the Audit Bureau Chief and designee via e-mail of appeal requests which taxpayers mistakenly send to OOA. OOA will also notify the Audit Bureau Chief and designee via e-mail, if OOA receives the Form DR-1 from the taxpayer.

An automated report will notify OOA and the Audit Division that an AWB case is pending appeal when the Appeal Date is entered in AWB.

## **Non-AWB Case Files**

The applicable Audit Bureau will send an e-mail **Transmittal Memo** to the Director of OOA with copies to the Audit designee. For each non-AWB case, the memo will contain the following information:

- Taxpayer's name,
- Complete nine digit identification number
- MATIS#
- Tax type
- Tax periods
- Unit/Location Code
- Name of Audit contact person and phone number
- SOL date or date of execution of Form B-37
- Election to participate in conference
- Brief description of the appealed issues(s) and position(s)
- Paper file exists? Yes or No
- Bureau Chief, Director and Supervisor Name to clarify who should be contacted by OOA
- Taxpayer Contact (e.g., name and title)

The Audit Division will be responsible for ensuring that the NIA is put on hold. The Audit Division is responsible for entering the proper notifications on the MASSTAX system so that assessments are not made after the expiration of the relevant hold period. Audit will review the case to make certain that the case is placed into or still in NIA status "030". If the case has yet to be billed, but is in status "040", the supervisor or manager should take the case out of the billing process by putting it back in "030" status.

Audit will return a copy of the completed Form B-37 to the taxpayer, insert a copy into the audit case file and retain an electronic copy on the shared drive "s-drive" until the case is completed. A copy of the completed Form DR-1 will be kept in the case file and the original is sent to OOA. If the Form B-37 is not secured within thirty (30) days, Audit will verify the existing statute of limitations and note in the above e-mail that the taxpayer was unwilling to execute a Form B-37.

## **AWB Case Files**

If the Form B-37 is received, an authorized Audit manager will countersign the Form B-37 submitted by the taxpayer; scan and attach the copy of the Form B-37 into the AWB Case and return the copy of the executed Form B-37 to the taxpayer.

For routine cases with properly submitted Forms DR-1 and B-37, Audit should enter the Appeal Date on AWB no later than five (5) days from the date of the written request for

appeal. A note should be entered in the Appeal Notes text box of the Appeal section in the AWB-Summary stating that a transmittal memo is attached explaining the issue or issues being appealed. Note: The completed Form DR-1 and executed Form B-37 will be attached under the Office of Appeals category in AWB-Attachments. The transmittal memo should also be included in the Office of Appeals category in AWB-Attachments and should be labeled "Transmittal of Appeal".

If a taxpayer submits a written request for appeal, but does not submit a Form B-37 or DR-1, an Appeal Date should still be entered within five (5) days of the written request (unless the taxpayer has been granted additional time to resolve the disputed matter(s) -- see footnote 1 below). However, a note should be added to the Appeal Notes text box explaining that the DR-1 and B-37 have not been submitted and that Audit is attempting to secure both. The note should also explain if a transmittal memo is attached or when one will be attached. When the forms are secured, an appropriate note should be added to the Appeal Notes text box.

Generally, If a Form B-37 or DR-1 is not secured within thirty (30) days of the written request for appeal, Audit will verify the existing statute of limitations via the AWB system, and document in the Appeal Notes text box that the taxpayer has failed to execute a Form B-37 and/or DR-1.

## **All Case Files**

For short statute cases (90 days or less remaining from the date the taxpayer submits a written appeal on field audit and 45 days or less on desk audit) immediate e-mail notification should be made to OOA including the specific information listed in the Non-AWB Cases heading as well as the AWB Case ID.

If the case has already been assessed (status "100") the supervisor/audit manager should notify the Director/Chief who in turn should notify the Office of Appeals.

## **AWB Appeals Process**

When a request for appeal is received in writing, the Audit Division will also be responsible for ensuring the NIA is put on hold. The Audit Division will be responsible for entering the proper conditions on the AWB system so that assessments are not made after the expiration of the relevant hold period. Upon receipt of a written appeal request, Audit will enter the following conditions into the AWB system<sup>1</sup>:

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<sup>1</sup> For cases in which additional time has been granted to the taxpayer in an attempt to resolve the disputed matter(s), these conditions should be entered when the appeal request is completed, i.e., Forms DR-1 and B-37 are received. This requirement, of course, assumes the taxpayer wishes to proceed with

- Check the Appeal box.
- Enter the Appeal Date using the calendar dropdown field. Note: The determination of the Appeal Date may vary among bureaus depending on what written request for hearing is received first. Regardless of which form is received, it is the date of the first written response that should determine the Appeal Date.
- Enter any notes in the Appeal Notes text box, especially notes that will be useful to OOA. Audit will include the Chief, Director, and Supervisor name directly in the text box to clarify who should be contacted by OOA. Audit will also include the Taxpayer Contact (e.g., name and title). In addition, the following notes will be helpful: Form DR-1 is pending, a prior audit case with OOA results or attaching the OOA Transmittal Cover memo to the Office of Appeals category of the AWB-Attachments for the case. Note: Transmittal cover memos may be used for Field Audit cases and complex issues in the Bureau of Desk Audit (BODA).

Note: In most cases, the SOL will be updated by the Audit Division when the Form B-37 is received. Note: OOA will have access to the update the SOL *after* case assignment by the OOA Manager.

Appeal	
Appeal: <input checked="" type="checkbox"/>	Appeal Date: 10/10/2007
Appeal Notes:	Sample notes here.
Appeal Completed: <input type="checkbox"/>	Appeal Completed Date: 5/27/2008
Appeal Disposition:	

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its appeal rights. Generally, if the Forms DR-1 and B-37 are not received within 60 days of the NIA the conditions should be entered as soon as possible thereafter, but no later than 5 days beyond the agreed to due date.

Primary Info		
Name:	Case Type:	Created:
FEIN:	Case Sub Type:	Department:
Address:	Case Source:	User:
Details:	Case Status:	Last Comm:
	Hold Status:	Period Begin Date:
	Next Step:	Period End Date:
		Current SOL Date:

Case Details	
Case ID:	Case Status:
Case Type:	Start Date:
General Reason:	Department:
Specific Reason:	Primary User:
Case Amount:	Hold Status:
Appeal Date:	Hold Reason:
Appeal Notes:	Hold Expires:
Appeal Completed Date:	Power of Attorney:
Appeal Disposition:	Combined Group:
Case Flag:	Parent Case:
	Parent Case ID:

## 2. AVAILABILITY OF THE CASE FILE FOR OOA

Generally, once the Audit Division receives a new appeal all audit activity with respect to that case should cease and no adjustments may be made by Audit to the NIA. An exception, of course, is when the taxpayer and Audit are attempting to resolve disputed matters during an extended NIA period. See – **Request for Conference Section above.**

At the time of NIA issuance, any case file should be complete in terms of content. The audit log, any narrative (except for certain BODA cases), and the exit conference letter should be included and up-to-date.

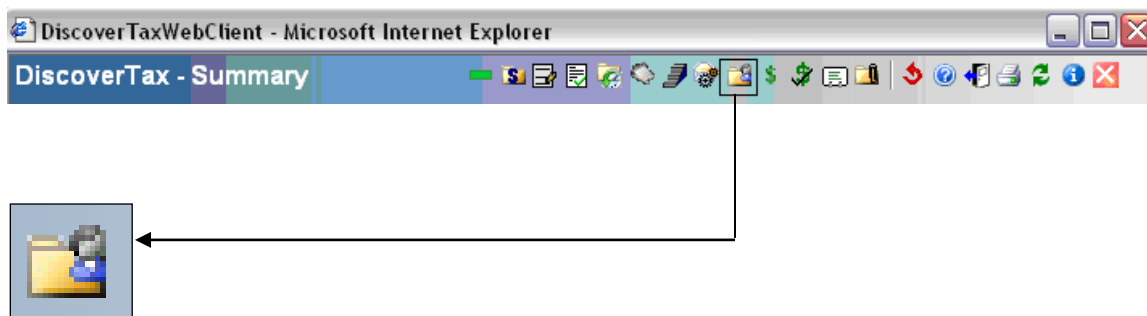
### AWB Appeals Inventory

The Office of Appeals manager can view newly appealed cases through a report in AWB.

Views	View Results					
Edit	Result ID	Result Count	Locked	Executed By	Executed Date	Custom
Generate New	96029	299 N		BOTELHOE	05/26/2008	Yes
Execute Custom	94959	299 N		BOTELHOE	05/21/2008	Yes
Schedule Offline	88272	254 N		BOTELHOE	04/22/2008	Yes
Schedule Custom	71320	242 N		RSISTAGE	02/21/2008	Yes
Result Details						
Case Creation						
Purge Result						
Score Requests						

After a few seconds, AWB will display the list of appealed cases.

The Office of Appeals manager assigns appealed cases in AWB to Appeals Officers using the “Unassigned Appealed Cases Result Detail”.



**DiscoverTaxWebClient - Microsoft Internet Explorer**

**DiscoverTax - Case Assignments**

**Primary Info**

Name: [REDACTED] Case Type: Multistate Income Created: 10/19/2006  
 FEIN: [REDACTED] Case Sub Type: Houston Department: Audit Department  
 Address: [REDACTED] Case Source: Selection User: [REDACTED]  
 Details: [View...](#) Case Status: Open Last Comm: No Entries  
 Hold Status: N Period Begin Date: 01/01/2000  
 Next Step: Audit Period End Date: 12/31/2002  
 Current SOL Date: 12/25/2007

**Assigned Users**

User ID	User's Role	Date Assigned	Phone Number	Phone Ext.
[REDACTED]	Primary	11/02/2006		

**Assign New User** **User Information**

Unassign User  
 Modify User Role

User: [REDACTED] Phone:  
 Role: Primary Extension:  
 Date Assigned: 11/02/2006 Fax:  
 Office Code: AUDIT  
 Office Location:

Copyright © Revenue Solutions, Inc. All Rights Reserved WARNING! CONFIDENTIAL User: [REDACTED]

- Select new role of Appeals Officer. See below.

New Role: OOAOfficer ▼

## MASSTAX Notes

It is the responsibility of the auditor/supervisor to ensure that a case “Note” is put on MASSTAX to indicate that the case is at OOA. The “Note” should be entered on MASSTAX within five (5) business days of receiving the taxpayer’s written request. The information for the note should include the auditor’s name and phone number, the tax type and tax periods involved.

## Attendance at Conferences

Attendance at conferences (either in person or via phone) is encouraged. Audit should note in the transmittal memo attached to the case if Audit would like to participate in the hearing. The Appeals Officer will send copies of the scheduling letters to the Audit personnel identified in the Appeal Notes text box.

## Dispute of issues and submission of new information

If Audit elects to comment on issues raised in the Taxpayer’s Form DR-1, it will generally do so at the time the file is made available to OOA. In those situations where new issues or information are raised for the first time on the Form DR-1, and circumstances do not allow sufficient time to properly address the matter prior to

referral, Audit may submit comments on those matters after the case file has been transferred to OOA. Any such comments should be submitted to OOA at least ten (10) days prior to the conference date. Audit will attach any such comments to the AWB file. When Audit attaches subsequent comments to the AWB file, it will trigger a notification e-mail to the Outlook account of the Appeals Officer.

During the course of an appeal, a taxpayer may submit, on its own initiative or at the request of OOA, information not previously possessed by the Department. OOA will forward the documentation secured to the Audit Supervisor in the New England Audit Bureau and the Filing Enforcement Bureau, the Audit Examiner in the Bureau of Desk Audit and the Audit Manager in the Multistate Audit Bureau.

Any correspondence received by OOA, which is addressed or cc-ed to the Audit Manager, should, in fact, be transmitted to the addressee via e-mail, and not solely attached to the AWB file. All notification correspondence sent by OOA should reference the AWB Case number.

OOA will scan and attach any new information to the AWB case and will ask Audit to review any significant new information.<sup>2</sup> Audit should review the new information and get back to OOA within a reasonable time frame. If the review is going to take longer than ten (10) business days, Audit should notify OOA to let them know when the review will be completed.

In addition, an AWB enhancement was implemented which will generate an automated outlook e-mail notification to the Primary Auditor, Supervisor, and Manager/Director, once a document (Attachment) such as an LOD, Settlement Agreement is attached to the AWB Case or a Case Log entry is added by OOA personnel.

### **3. FINAL DISPOSITION BY THE OFFICE OF APPEALS**

#### **OOA Processing of AWB Case Files**

During the appeals process and upon resolution by OOA, the Appeals Officer has the ability to access the AWB Case in his/her "Inventory" to document the appeals process. The Office of Appeals should perform the following steps to document and complete the appeals process:

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<sup>2</sup> OOA will scan up to twenty (20) pages of taxpayer documents. If the taxpayer submits voluminous records, Appeals will forward the paper documents to Audit.

Appeal	
Appeal: <input checked="" type="checkbox"/>	Appeal Date: 10/10/2007
Appeal Notes:	Sample notes here.
Appeal Completed: <input type="checkbox"/>	Appeal Completed Date: 5/27/2008
Appeal Disposition:	

- The Office of Appeals will populate the Appeal Completed Date which will trigger the SOL edit. The SOL date will adjust to ninety (90) days after the Appeal Completed Date **or** the “original” SOL date, whichever is later. Note: This adjustment will occur on the day after the Appeal Completed Date is entered.
- The case now appears on the AWB Report of Completed Appealed Cases.
- These actions by OOA prompt the case completed notification through AWB-Messages.

### OOA Disposition of Abatement Claims

OOA will send e-mail notification to the Bureau Chief of the initiating Audit Bureau for field cases only regarding the disposition of Abatement claims filed against field audit assessments. The e-mail notification should include the Letters of Determination, Settlement Agreements, Rejection Letters or Withdrawals.

### OOA Processing of Non-AWB Case Files

In cases where Settlement has been reached, OOA will send a copy of the executed Settlement Agreement, together with a cover memo, and any applicable settlement memorandum, to the Chief of the initiating bureau and the Deputy Commissioner’s designee within five (5) business days.

In cases where a determination letter has been issued following a conference, OOA will send a copy of the determination letter and any applicable file memorandum to the Chief of the initiating bureau and the Deputy Commissioner’s designee.

In cases where the request for pre-assessment settlement consideration has been rejected, or parties have been unable to reach settlement, and the taxpayer did not request a conference, OOA will notify the Chief of the initiating bureau and the Deputy

Commissioner's designee of the rejection. OOA will notify the taxpayer that the appeal has been closed and that such constitutes the final disposition.

In all cases, the audit case file will be returned to the Chief of the initiating bureau within five (5) business days of appropriate taxpayer correspondence.

The Audit Division should not infer from a settlement agreement that future cases would or should be settled on the same or similar terms with any taxpayer, including the taxpayer participating in settlement. Settlement agreements apply only to the tax years that were the subject of the audit and cannot be used by taxpayers to affect the outcome of future audits unless specified in the settlement agreement. Language is included in settlement agreements to inform taxpayers of this rule.

Note: Electronic versions of the Letter of Determination are preferred to expedite adjustments, if any.

### **Audit Processing of AWB Case Files**

Upon notification of the completed case by OOA, Audit should perform the appropriate actions in AWB to process the appeal determination by assessing, adjusting or rejecting the NIA.

### **AWB Report**

The Audit manager or supervisor is able to run a report in AWB that lists the appealed cases for which the appeals process was completed.

Completed Appealed Cases Not Interfaced Result Details (#96365)- UnLocked

Show Selection Code Options

Show Filter/Sort Options

Apply	Case ID	Updated By	Selection Codes	CASE_ID	BUREAU	LOC	TP_ID	TP_NAME
<input type="checkbox"/>	<a href="#">16450</a>			16450	NEAB	IW		

10

Change Paging

## **Audit Processing Non-AWB Case Files**

Upon receipt of the case file from OOA and related correspondence, the initiating bureau will ensure that MATIS is updated for the date the case was received from OOA and for the new statute of limitations date. Audit should perform the following steps to process the appeal determination:

- Make adjustments to NIA, if any, and issue revised NIA to the taxpayer.
- Update all case files received from OOA for all correspondence, revisions and other documents prior to forwarding the closed case file to the Records Management Bureau.
- Close the MATIS case upon approval by the supervisor or manager when the NOA posts to the taxpayer's account on MASSTAX.
- Include the updated penalty and interest amounts through the NOA date on the appropriate MATIS screen prior to closing.

## **Audit Referrals**

During the course of an audit, information on another taxpayer might be obtained and that warrants an audit referral.

Some examples of when audit referrals are to be initiated include:

- An investigation of a non-filer discloses that an audit is warranted;
- A taxpayer's business practices indicate the need of an audit to verify the accuracy and completeness of its tax reporting;
- An examination of purchases for use tax discloses that a seller is selling tax-free without the receipt of exemption or resale certificates;
- An examination of sales discloses that a customer is issuing invalid resale or exemption certificates; and/or
- An examination of the income apportionment formula discloses the taxable presence of a non-filing business.

The receiving unit must be able to evaluate the quality and merit of the referral to determine if the case is audit worthy and decide the assignment priority of an accepted referral.

The referral must include a narrative explanation as to why the case is being referred and how the referral was developed.

- In addition, the referral must be accompanied by all materials that document and support the referral such as copies of invoices and certificates (Form ST-4, ST-12, etc.). Any applicable tax returns already requested from the Records Management Bureau (RMB) together with a Form FR-1A - Transfer Sheet.

The Audit Referral Form, Form A-40C must be filled out completely and, if available, copies of contracts, certificates, audit schedules, invoices, newspaper articles or other pertinent data must be scanned and attached.

A sales tax auditor should state whether the items warranting referral were included in the audit of the taxpayer where the transaction was found.

### **Transmittal of the Completed Case Folder**

The completed case folder is sent to the Records Management Bureau (RMB) within five days from the date of assessment with two copies of the Transmittal Form, Form M-3210. The Administrative Assistant or Director's/Manager's designee assigned these responsibilities retains the third copy of the Transmittal Form. The Administrative Assistant or Director's/Manager's designee receives and retains the signed acknowledgment copy of the Form M-3210 from Records Management in order to confirm receipt of the case by RMB.

Note: With the implementation of the electronic audit case folder through Audit WorkBench (AWB), paper case files will not be generated. As a result, there will be substantially less completed case folders to transfer to RMB as time passes.

### **Report of Change in Massachusetts Income**

Changes in Massachusetts income must be reported to the federal government in conformance with the Agreement on Coordination of Tax Administration between the Commonwealth of Massachusetts Department of Revenue and the Boston District of the Internal Revenue Service for personal income and corporate excise tax audits when increases in gross income or decreases in deductions result from the examination.

Each report must be completed in sufficient detail by disclosing: statutory authority; records and/or documents examined; other basis for auditor's findings, etc. This information is essential for the reviewer to determine the propriety of the adjustments.

All changes must be reported on Form A-SAR1. The **Form A-SAR1** must be completed in duplicate and included in the auditor's report when submitted to his/her supervisor. Upon review and acceptance by the supervisor, the Director will send the report through the Bureau Chief to the Federal/State Exchange Officer. The Federal/State Exchange Office will forward all Forms A-SAR1 to the Internal Revenue Service.

Whether the information is scanned depends on the volume of the documents. If the taxpayer submits voluminous records, Appeals will forward the paper documents to Audit.

## Chapter 6

### Specialized Audit Procedures

#### Application of Penalty - Chapter 62C, Section 35A

Section 35A states "there shall be added to the tax an amount equal to 20 per cent of the portion of the underpayment to which this section applies." Underpayment is defined as the amount by which any tax exceeds the amount shown as tax by the taxpayer on the return. The section 35A penalty applies when it is attributable to either one or both of the following: (1) negligence or disregard of the tax laws of the Commonwealth or of public written statements issued by the Commissioner; or (2) any substantial understatement of liability for a tax referred to in chapter 62C, section 2. (1)

The determination of whether negligence or disregard exists should be based on all of the relevant facts available. Section 35A(c) defines negligence as the failure to make a reasonable attempt to comply with the laws of the Commonwealth or public written statements issued by the Department. Disregard includes any careless, reckless, and/or intentional act to ignore the laws or public written statements. These determinations need to be made on a case by case basis based on a review of all the available facts, but this procedure provides some guidance in the application of this portion of section 35A.

The determination of whether a substantial underpayment exists is a mathematical calculation. Section 35A(c) states that a substantial understatement exists if the understatement for the period exceeds the greater of 10% of the tax required to be shown on the return for the period or \$1,000. (2) The statute provides further that for purposes of determining the applicability of and calculating the amount of the penalty, the understatement shall be reduced by any portion of the understatement which is attributable to (1) the tax treatment of any item by the taxpayer if there is or was substantial authority for the treatment; or (2) any item if the relevant facts affecting the treatment of the item are adequately disclosed in the return or in a statement attached to the return, and there is a reasonable basis for the tax treatment of the item by the taxpayer. However subparagraph (2) does not apply to any listed transaction or tax strategy as defined under chapter 62C, section 35B. (3) As provided in TIR 06-5 adequate disclosure may be made for any issue by emailing a written statement to **disclosure@dor.state.ma.us**. (4) Alternatively, for returns filed under c. 62 or c. 63, adequate disclosure can also be made on Form TDS. In considering whether there is "substantial authority" for a non-disclosed position or a "reasonable basis" for a disclosed ("non-tax shelter") position, auditors should interpret the term consistently with the use of the term in IRC Sec. 6662(d).

The section 35A penalty may also be waived for reasonable cause under section 35B. The Commissioner was granted the authority to issue regulations under section 35B to provide circumstances under which the section 35A penalty may be waived in the

interest of efficient administration of the tax laws of the Commonwealth. The Interest, Penalties and Application of Payments Regulation (830 CMR 62C.33.1) does not address the basis for waiver of section 35A penalties under this standard. However, we have developed the following procedures to assist in the determination of when to impose the section 35A penalty. We believe that these procedures further the intent of section 35B and provide for more efficient administration of our tax laws.

Therefore, in an effort to have more uniform application of the section 35A penalty the following procedures will be put in place:

First we must determine if an understatement on which a penalty may be calculated under section 35A exists. Therefore, we must determine the additional tax due for the period. From that we subtract the following amounts:

- a. Any portion of the additional tax due that relates to a transaction for which there was substantial authority for the taxpayer's treatment of the item.
- b. Any portion of the additional tax due that relates to a non-listed transaction that was adequately disclosed on the return, on Form TDS or in an email as provided in TIR 06-5 and there was a reasonable basis for such position.
- c. In general any portion of the additional tax due that relates to income that was reported to a state and taxed at a substantially similar rate in such state. (For example a corporate taxpayer throws back sales to another state and as such the income was taxed in such state. We determine that all or a portion of those throw back sales should have been thrown back to Massachusetts. In this case the taxpayer paid tax to another state on such income and we will generally reduce the amount of understatement for the tax associated with this issue.) See the last paragraph of these guidelines, below, with respect to potential exceptions to these guidelines.
- d. In general any portion of the additional tax due that relates to tax that a taxpayer voluntarily reports on an amended return without any contact from the Department. (If a taxpayer files an amended return after being contacted by the Department, the penalty may be assessed with respect to the amount of additional tax shown on the amended return as well as additional tax that might be assessed on an NIA. An NIA may be issued for the penalty at any time within the normal period for making an assessment. "Contact from the Department" should be construed broadly with respect to corporations that are part of controlled groups. Similarly shareholders in pass-through entities that are under audit may not be eligible for this relief with respect to items related to the pass-through entity.)

Any balance remaining due is the understatement for the period for purposes of section 35A. If this understatement is greater than 10% of the tax due for the period and \$1,000 then we have a substantial understatement for the period. When a substantial understatement exists we will generally propose the 20% penalty on the amount of the substantial understatement. However, the likely purpose of the section 35A penalty was not to raise revenue, but to foster compliance and preclude taxpayers from using

abusive transactions. In addition, section 35B contemplates that we must take into consideration the efficient administration of the tax laws before imposing the penalty. Considering these factors we will generally seek to impose the section 35A penalty for a substantial understatement where one or more of the following minimal criteria are met:

- a. A substantial understatement exists in 20% or more of the audit periods, or
- b. For the periods in which the substantial understatement exists, the tax (without regard to the other audit adjustments) was collected and not remitted, or
- c. The taxpayer's compliance history and internal controls have been determined to be inadequate, or
- d. The understatement relates to a recurring issue from a prior audit that was upheld or substantially upheld and the prior audit concluded before the period currently under audit began, or (5)
- e. Any subsequent situations in which by regulation, other public written statement, or internal procedures the Department determines that the section 35A penalty should be imposed.

If any of the above conditions are met we will impose the section 35A penalty on the substantial understatement. It may also be imposed in other cases as the facts may warrant.

The Section 35A Penalty Calculation Spreadsheet must be used by the auditors to determine if a section 35A penalty applies for a substantial understatement, and the amount of such penalty. In the first column the auditor enters the audit periods. In the next column the auditor enters the tax originally reported by the taxpayer. In the third column the auditor enters the additional tax due per audit as well as any additional tax filed with an amended return. In the fourth column (Adjustments to Understatement) the auditor enters any reductions to the understatement amount for the items discussed above, such as any additional tax voluntarily reported with an amended return and no contact from the Department. The spreadsheet will then calculate any penalties that are determined to be due for a substantial understatement. The auditor does not include this schedule with any preliminary workpapers provided to the taxpayer, but does attach it to the AWB case file. The auditor will review this schedule with his or supervisor/manager to determine whether the minimum criteria have been met. If the minimum criteria have not been met an audit log entry will be made stating such and, generally, that no penalty will be imposed. If one or more of the minimum criteria have been met, or a penalty is otherwise determined to be appropriate, the taxpayer should be informed that the penalty will be imposed. The penalty should now be reflected on the assessment summary workpapers provided to the taxpayer. The auditor must include an explanation in his or her narrative explaining that a penalty is being imposed under section 35A for a substantial understatement. This should also be explained to the taxpayer in the 10 day letter or the exit conference letter.

At times a substantial understatement may not exist, but we may nonetheless assess the section 35A penalty for negligence or disregard of the tax laws of the Commonwealth or public written statements issued by the Commissioner. The determination of when negligence or disregard exists is to be made on a case by case basis; however, we believe the following should be used as a guide in determining when to impose the negligence or disregard portions of section 35A.

a. When the underpayment is less than \$1,000, but is greater than or equal to 100% of the tax reported we may impose the section 35A penalty for negligence or disregard. Beyond just meeting this mathematical calculation there must be other factors that show that the taxpayer was negligent or disregarded the tax laws of the Commonwealth. (For example we have a cigarette retailer's purchase information. The retailer only reports a minimal amount of sales, which results in \$50 or \$100 of tax per month. Our review of its purchases show that the retailer should have been filing \$500 per month in tax. In this situation negligence or disregard exists. The taxpayer knew that its sales were taxable as evidenced by its prior filings. The taxpayer just neglected to report all its sales. The penalty will be imposed in this situation.)

b. When the underpayment is less than 10%, but greater than \$1,000 the penalty may be imposed if we can show that negligence or disregard existed. Here we must show that the taxpayer either was negligent or carelessly, recklessly or intentionally failed to comply with the Commonwealth's tax laws or public written statements issued by the Commissioner. (For example a corporate taxpayer is paying intercompany royalties and/or interest to a related affiliate. The corporate taxpayer does not file a schedule ABI or ABIE and does not complete the relevant lines of the schedule E of the tax return. Consequently, the corporate taxpayer deducts the inter-company interest and/or royalties. We audit the return and determine that the corporate taxpayer is not entitled to the deduction. Our proposed assessment amounts to \$50,000 for the year, but it is still less than 10% of the overall tax originally reported. In this circumstance we will impose the penalty because the taxpayer failed to comply with the statute, public written statements, and the tax forms.)

c. Any other situation in which the facts clearly establish that the taxpayer either was negligent or recklessly, carelessly or intentionally disregarded such tax laws or public written statements and that the penalty applies.

Before proposing a section 35A penalty for negligence or disregard the auditor must discuss the matter with his or her supervisor/manager. If the supervisor/manager agrees with the auditor, the auditor must include an explanation in the narrative stating the reasons why the section 35A penalty should be imposed for negligence or disregard. The explanation should state all of the facts as to why the penalty should be imposed. (For BODA employees, if a narrative is not completed the explanation should be contained within the audit log.) The penalty should now be reflected on assessment summary workpapers provided to the taxpayer. This should also be explained to the taxpayer in the ten day letter or exit conference letter.

In any instance when a penalty is being proposed under Section 35A, the taxpayer will be notified (where practical, before the issuance of an NIA). The taxpayer should be informed of its rights to request a waiver of penalty even if the rights were previously explained to the taxpayer. If the waiver request is filed with Audit, it will be handled under existing procedures. Auditors considering such requests should refer to federal regulations and case law in addition to the Department's own procedures. (6)

These are general guidelines and require discretion in their implementation. The Audit Division reserves the right to amend or revise these guidelines and to impose or waive the penalties construed herein where circumstances require notwithstanding provisions to the contrary.

Footnotes:

(1) This would include chapters 62 through 65A, section 10 of chapter 121A, and section 21 of chapter 138.

(2) For this purpose, the tax required to be shown on the return is the correct tax for the tax period (excluding penalties). Both the understatement amount and the amount required to be shown on the return are calculated without reduction for taxes withheld or estimated tax payments.

(3) Currently the only transactions that are listed transactions are those that are defined by the IRS as listed transactions. However, the Department has reserved the right to apply the relevant penalties to additional abusive transactions or tax strategies. See TIR 06-5.

(4) The email disclosure may, but is not required to be, in the form of a properly completed federal Form 8275 or 8275R. TIR 06-5.

(5) This criterion will not be considered as having been met if the understatement relates to tax on an issue that is currently on appeal from a prior proposed assessment or assessment.

(6) The guidelines in AP 633, as currently published, are specific by the type of penalty however, part VI states that the standards for waiving or abating section 33 penalties may be applied to other penalties imposed under MGL Ch. 62C or 62B, where appropriate. AP 633 and section 35B both have a reasonable cause standard: however, the AP states there must be reasonable cause and not willful neglect whereas section 35B states there must be reasonable cause and the taxpayer must have acted in good faith. Thus, while similar it appears there is a less stringent burden on the taxpayer's behalf under section 35B. Lastly with respect to applying AP 633 a taxpayer should be able to rely on the advice of a tax professional to avoid this penalty only where it can be demonstrated that the tax professional had been furnished all necessary and relevant information and provided incorrect advice. Otherwise any taxpayer who had their return professionally prepared could claim an exception to the penalty under section 35A.

## **Disclosure**

Audit Division employees are entrusted with a variety of records and information either maintained by DOR or obtained during the audit process. Some of the information maintained by DOR is public and is made readily available to those who request it. However, certain records including audit information are confidential, and we are legally bound to protect the taxpayer's right to privacy.

## **Public or Confidential**

### **Tax Information to be Treated as Confidential**

Employees may not browse, publish, divulge or make known, in any manner, except as provided or required by law, any tax return, information contained in any tax return or in any schedule, list or other statement designed to supplement or to become a part of a tax return. Employees also may not publish, divulge, disclose or make known in any manner or to any extent not authorized by law any information resulting from any examination or investigation or contained in any report, record or electronic data source, when the information concerns or relates to: trade secrets, processes, operations, style of work or apparatus, or to the identity, confidential statistical data, amount or source of any income, profits, losses, or expenditures of any person, firm, party, corporation or association. When a question arises as to whether an item of information may be disclosed, the employee shall discuss the facts with his/her bureau chief who will request an opinion from the Litigation Bureau, if needed.

## **Requests for Information**

All requests for public records should be directed to the Rulings and Regulations Bureau which shall determine whether the requested documents are public records in accordance with MGL, Chapter 4, section 7, cl. 26.

## **Information Safeguards**

The primary safeguard to be employed is common sense. In the area of confidential tax information, it is always best to err on the side of caution because the taxpayer's privacy, as well as stiff fines, dismissal and imprisonment are at stake.

Pursuant to recently-enacted state law (Chapter 93H - Security Breaches), DOR will be required to notify the Attorney General, Director of Consumer Affairs and the affected individual when there is an unauthorized acquisition or use of such individual's personal information (including name, social security number, driver's license number, and financial account number or credit card or debit card number, with or without any required passcode).

As you know, existing law and our own longstanding, strictly enforced policy prohibit DOR employees from "browsing" or accessing taxpayer or child support customer information without a legitimate business purpose on MASSTAX, COMETS or any

similar electronic or other database. As a DOR employee, you receive training and reminders about your obligations and the penalties, including suspension, employment termination and criminal prosecution for violation of these principles.

In addition to the penalties currently in place, DOR will now be required to provide written notification to the Attorney General, Director of Consumer Affairs and the affected individual when a DOR employee engages in any unauthorized "browsing" or access of an individual's personal information on MASSTAX, COMETS, Registry of Motor Vehicles database, or any other electronic or other database.

The following are rules to follow:

- If an employee of the taxpayer questions the auditor about a part of the audit not within his or her own operating duties, the auditor should decline to comment until cleared with the designated taxpayer contact.
- When in doubt, an auditor may require a written request before releasing information. However an auditor cannot require the requester to state a reason.
- If the auditor is not familiar with the requester through contact during an audit, steps need to be taken to ensure that the requester is entitled to the information. Steps may include:
  - If personally visited, a letter from the primary taxpayer contact or other identification.
  - If written request, verification that the return matches the taxpayer's address.

If, phone inquiry, questions to determine entitlement to information i.e., calling back after discussion with taxpayer's designated contact.

If after review of these materials and auditor still has doubts as to whether or not information should be released, the Manager/Director must be contacted.

### **Inadvertent Disclosure**

Confidentiality can be betrayed without intent through carelessness. Although unintentional, this disclosure is also very serious. To prevent inadvertent disclosure an auditor will take the following precautions:

- Locking desk overnight and not leaving confidential information displayed.
- Signing off computer terminals;
- Locking briefcases when unattended at audits; and
- Locking cars when they contain audit files or other sensitive information.

## **Examining Records**

Most taxpayers see audits as a normal business occurrence and are not concerned about possible disclosure of information seen or compiled. Yet some taxpayers are apprehensive. An auditor will examine records that include these sensitive areas:

- Customer listings
- Pricing policies/markup
- Employee pay
- Vendors
- Lawsuit information
- Financial condition

However, sensitive records that are necessary to conduct an audit cannot be withheld. Massachusetts General Laws, Chapter 62C, section 24 authorizes the Commissioner to examine books, records, papers and other data of any entity for the purpose of verifying any return filed with the Commonwealth.

If the taxpayer expresses concern, the auditor can reference Chapter 62C, section 21 and 830 CMR 62C.21.1, establishing the confidentiality of all information obtained during the course of an audit.

## **Removal of Records from Place of Business**

When it becomes necessary to remove records from a taxpayer's premises, or a taxpayer delivers records to the office, a Taxpayer Document Receipt Form must be issued.

The taxpayer receives the receipt when records are taken and signs it when the records are returned complete and intact. This information is confidential and appropriate safeguards should be taken.

## **Maintenance of Records by the Auditor**

Auditors should take extreme care in protecting taxpayer's records that are kept within their possession. This includes records taken from the taxpayer's premises, e.g. worksheets, invoices, summaries, etc. (see above) and records obtained from our own files, e.g. returns, old audit folder, etc.

At work, the auditor should always make sure that records are not left unattended and assessable to passersby. At an audit site the records, if not electronically stored, should be locked in a briefcase or taken with the auditor when he or she goes to lunch or takes breaks. If electronically stored, the auditor should log off the computer, and store the computer in a locked room or cabinet. In addition, diskettes should always be stored in a secure area. In the office, auditors should never leave taxpayer's records unattended

after the completion of a work day. All records should be locked in the auditor's workstation.

In transit, the auditor must never leave briefcases and laptops, containing taxpayer records unattended in their automobile and visible to passerby's. Briefcases and laptops should be locked in the trunk, or at a minimum stored within the car out of sight with the car doors locked. In the evening, auditors must bring all of the taxpayer's records into their house.

Satellite auditors, when not in their office at home, must always secure taxpayer's records in a locked file cabinet supplied by the Department.

## **IRS Documents**

When federal tax information (FTI) is needed, it should be requested from the taxpayer. If the taxpayer is unable or unwilling to provide the information, the Department can obtain it directly from the IRS through the Federal/State Exchange Office.

In a change of IRS policy, DOR can now enter FTI, in as much detail as you want, as a taxpayer "NOTE" or case note "CSNT". Using the note and case note screens on MASSTAX allows transaction tracking to monitor the unauthorized access of FTI.

A request from the Manager/Director to the Bureau Chief will include:

- Taxpayer name;
- Federal Identification Number;
- Documents needed (accounting years ending xx-xx-xx);
- The reason information is needed;
- Specify whether a return or transcript is needed; and
- Other states' tax return information.

Due to disclosure rules, the IRS documents are retained in a secured area by the Federal/State Exchange Officer. An auditor may view this information and take notes, yet will not be able to make copies. These notes are as confidential as the documents that are their source.

Audit Division regional managers and/or directors are authorized to directly contact other states' disclosure officers in order to obtain state tax return information filed with that state and needed in connection with an audit.

## **Why Am I Being Audited?**

When conducting an audit due to a fraud investigation, customer complaint, ex-employee complaint, etc., the source of the referral must not be conveyed to the taxpayer. The name of an informant or the information provided must not be revealed.

An auditor will take safeguards to ensure this information does not become an issue by leaving this information in the office.

If an audit is generated through a referral (i.e., a transaction seen in another audit) it is best to follow the above procedures. However, if after review of the taxpayer's records, this transaction is not uncovered, it may be necessary for the effective administration of state taxes to reference this transaction after receiving approval from the Manager/Director.

## **Proprietary Software**

Although not confidential, the software licensed by the State cannot be copied to pass along to someone else. In addition, non-licensed software must not be used on State equipment.

Violations to State software licenses can expose both the State and the employee to litigation involving copyright law.

## **Administrative Summons**

An Administrative Summons is a statutory demand for taxpayer records and/or testimony, if a taxpayer refuses to comply voluntarily, and is issued pursuant to the authority vested in the Commissioner under MGL, Chapter 62C, section 70, Sample Form.

If an auditor encounters difficulty in obtaining books, records, documents or other information essential to the proper completion of the audit, the auditor should discuss the need to request the issuance of an Administrative Summons with his/her supervisor in order to compel the production of records and/or testimony.

All requests for the issuance of an Administrative Summons must be approved by the auditor's Chief of Bureau, who will forward the request to the Deputy Commissioner of the Division for drafting. The Request for Administrative Summons will be submitted to the Litigation Bureau of the Legal Division to prepare and to serve on the appropriate party. See the sample Request Form. If a taxpayer or other party fails to comply with the summons, the Chief of Bureau will request an enforcement of the summons by preparing a Request for Summons Enforcement Form. The Deputy Commissioner will approve and forward the request to the Litigation Bureau. A sample Request for Summons Enforcement Form.

## **Bankruptcy**

With fluctuating economic conditions, bankruptcy has become a significant topic in auditing. In this section, the types of bankruptcy are listed along with the events and audit guidelines to help the auditor understand how it relates to the audit.

## Administration of Bankruptcy Cases

The DOR's Litigation Bureau has a Bankruptcy Unit which is responsible for working exclusively with taxpayers who have filed bankruptcy.

Bankruptcy cases are started when a taxpayer such as an individual, husband and wife, corporation, partnership or other entity, files a bankruptcy petition with the federal Bankruptcy Court. The calendar date on which the bankruptcy petition is filed is known as the Petition Date.

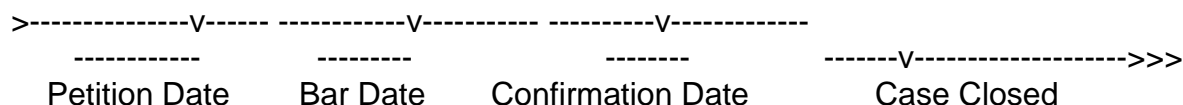
## Confidentiality

DOR staff must adhere to confidentiality restrictions and not discuss or reveal any confidential information regarding the bankruptcy case with any party other than the taxpayer.

## Bankruptcy Events

The following time line shows:

Typical timing requirements, but the sequence of events may vary:



1. Petition Date (Petition for bankruptcy filed) - case is begun by specifying the particular chapter under which relief is requested. May be voluntary (debtor files petition) or involuntary (creditor files the petition). The State is a secured priority creditor if liens have been filed prior to the filing of the petition. Otherwise, it is usually a priority creditor and is paid before the general unsecured creditors.

## Automatic Stay

When a taxpayer files the bankruptcy case, an automatic stay is placed into effect **immediately**, as of the hour and minute on the Petition Date, and prohibits all of the taxpayer's creditors, including the Department of Revenue, from taking any action to collect any debts or liabilities that relate to the time period before the Petition Date.

The Bankruptcy Court is authorized under federal law to impose damages for a willful and knowing violation of the automatic stay.

**Note: Damages can be awarded against DOR as well as its employees both personally and individually. It is extremely important that all DOR staff comply with the automatic stay.**

The following is a list of actions that are specifically prohibited by the imposition of the automatic stay:

- Contacting the taxpayer to request or demand payment;
- Sending notices of demand for payment;
- Recording liens or issuing levies;
- Proceeding with action to revoke a license; and
- Taking any other action whatsoever to collect any unpaid tax.

2. Bar Date or File - By Date (Proof of claim filing deadline) - the date by which a claim must be filed in order for the claim to be considered and for the creditor to be listed. In Chapter 7 and 13 cases this date is always 90 days after the first Section 341 meeting of creditors; in Chapter 11 cases, a bar date may be set by the court on motion of a party in interest (usually the debtor); the bankruptcy judge decides the actual date. **If the State does not file a proof of claim prior to the bar date, the State's claim for taxes in some instances may be discharged.** The proof of claim can be an estimate at the time of filing, and can be changed later to a more definite amount even after the Bar Date provided the final claim is for the same tax type(s) and same tax period(s).

3. Confirmation Date (Confirmation of plan/discharge) - the date at which the plan for reorganization and discharge of debts is accepted by the court. The Department may still be permitted to make an assessment of a discharged debt if the Department's purpose is to pursue a non-debtor party for the discharged debt. The discharge generally runs in favor of the debtor only, not a non-debtor party, as, e.g., a responsible person. If a taxpayer is bankrupt and did not file returns and remit tax collected, the taxes collected generally will not be discharged by the bankruptcy court unless the Chapter 11 or Chapter 13 reorganization plan allows for such a discharge.

4. Case closed.

## **Audit Guidelines**

The following general guidelines should be followed to protect the State's interest:

- Review the MASSTAX inquiry screen TRBK, in all cases, to determine if the taxpayer's account indicates bankruptcy status.

Records to be requested:

- If the taxpayer is in bankruptcy, and is not reflected on MASSTAX Screen TRBK, ask for a copy of the Section 341 Notice or Petition for Bankruptcy and send to the Bankruptcy Unit.
- If the taxpayer states that his or her bankruptcy is near the confirmation date or a discharge, ask for a copy of the Notice of Discharge, the order confirming the Plan, the Plan itself, and forward to the Bankruptcy Unit.

- Review the MASSTAX Screen TRBK inquiry for information on the bankruptcy. (This inquiry may not be current due to the lapse of time between filing and the State's being notified.)
- The auditor should immediately contact and apprise the audit supervisor of the situation.
- The taxpayer's name, location of the Bankruptcy Court, the Bankruptcy Court docket number and the Petition Date should be obtained and forwarded to the Bankruptcy Unit if the taxpayer, taxpayer's representative or non-attorney representative informs DOR staff of the bankruptcy case.
- Contact the Bankruptcy Unit by telephone, email or fax. A bankruptcy examiner will work with the auditor to determine how the audit will proceed and the time frame within which the audit must be conducted. Do not hesitate to ask the Litigation Bureau for assistance at any time.
- These actions are specifically **not** prohibited by the imposition of the automatic stay:
  - The commencement, continuation, and conclusion of a tax audit;
  - The issuance of a tax deficiency (NIA);
  - A demand for tax returns;
  - The making of an assessment for any tax and issuance of a notice of demand for payment of such an assessment (NOA), which combines in one document the notice that the assessment has been made, which is required by MGL Chapter 62C, section 31, and a demand for payment.
- Any audits that are currently in progress on the Petition Date are **not** affected by the automatic stay and can proceed to assessment through the normal steps including conference and NIA, etc.;
- Any audit commencing after the Petition Date may include tax periods before or after the Petition Date, however, Audit Division staff **should** notify the Bankruptcy Unit of the existence of the audit, so an estimated proof of claim can be filed;
- MGL, Chapter 62C, section 26(b) specifically suspends the running of the three year period for making an assessment during the period of time that a taxpayer has a bankruptcy case pending under the appropriate chapters of Title 11 of the United States Code.
- When the audit is completed, Audit Division staff **should** inform the Bankruptcy Unit of the audit results so the proof of claim can be amended to represent the correct tax liability.

Note: Periods subject to audit should include those that occur within the three-year statute of limitations from the date the return was filed while the case is in bankruptcy.

- If a Chapter 11 taxpayer has a **confirmed** Plan of Reorganization, then only audit post confirmation periods. Remember that all pre-confirmation taxes are automatically discharged by the bankruptcy court order approving the Plan of Reorganization. Always check the MASSTAX taxpayer "NOTE" screen to see if a Chapter 11 case was filed and, if so, when the Plan of Reorganization was approved. Any tax credits and/or taxes due before that date are discharged and

cannot be audited, except as to Trust Fund taxes. See note at paragraph 3 under Bankruptcy Events. Also, in some limited situations, it is permissible for the Department to set off a discharged debt against a refund due for a pre-petition period.

- If the taxpayer has not yet filed for bankruptcy but is about to, or the auditor feels that the taxpayer has financial problems such that collection of taxes would be jeopardized, the auditor's supervisor should also determine whether the audit should be expedited so that a jeopardy determination can be issued. An immediate request for lien filing may be sent to the Collections Bureau.

Note: There are no set guidelines for determining when a jeopardy determination should be issued. The auditor should obtain as much financial information about the taxpayer as possible and discuss the situation with the supervisor and/or manager.

- Standard auditing and write-up procedures should be expedited on all bankruptcy audits. In some cases, figures may be phoned in to the Bankruptcy Unit for claim filing.
- Determine the final amount of the deficiency, both pre-petition and post-petition, prior to the confirmation of the plan. If possible, estimate the liability prior to the bar date and request that a claim be filed. The claim can be amended later when the actual amount is known. Notification of sampling procedures is required for all estimates.
- Consider a penalty waiver as usual.
- Redetermination requests will be the same as for all other taxpayers.
- Under **Section 505(b) of the Bankruptcy Code {11USCS.505(b)}**, a trustee (including presumably a debtor-in-possession) in a bankruptcy case may make a written request for a determination of any required liability of the bankruptcy estate for any tax incurred during the administration of the bankruptcy case. By making such a written request along with filing of a tax return for such tax and payment of the tax shown on the return, the trustee, the debtor and any successor to the debtor may obtain a discharge from any further liability for such tax if the Department does not notify the trustee within 60 days after such request, that this return(s) has been selected for audit or the Department fails to complete the audit and fails to notify the trustee of any tax due within 180 days after such written request by the trustee. Some courts have held that a taxing authority's failure to notify the trustee within 60 days of the written request and payment under this provision even results in a discharge of interest and penalties attributable solely to the trustee's late filing of the return and late payment of the tax. Consequently, if an auditor receives such a written request for a so-called "quickie audit", he/she should insure that all processes, including billing, are expedited so that the trustee receives notice from the Department within 60 days, and so that any resulting audit is completed within 180 days.
- The Bankruptcy Unit and attorneys from the Litigation Bureau are responsible for arranging payment of DOR's tax claim and for resolving or litigating any disputes regarding the legality or the amount of the tax claim.

- After the taxpayer's case is closed in federal Bankruptcy Court, the Bankruptcy Unit will list any unpaid tax claims that are not affected by the bankruptcy and will forward the case to the Collections Bureau the necessary action.

## **Types of Bankruptcy**

### **Chapter 7 – Liquidation**

- Available to:
  - Corporations
  - Partnerships
  - Individuals
- Provides that all or substantially all of the property be liquidated.
- Provides the individual a discharge of debts except for most taxes. Corporations and partnerships do not receive a discharge of debts.
- Corporations should be liquidated, dissolved and uncollectible.
- Upon filing of petition, business operations are to be terminated, unless, Chapter 7 trustee obtains specific order from Bankruptcy Court allowing him/her to operate business.

### **Chapter 9 – Municipalities**

- Available to governmental authorities.

### **Chapter 11 – Reorganization**

- Available to:
  - Corporations
  - Partnerships
  - Individuals
- Generally provides for a reorganization of the entity.
- Provides a discharge from pre-confirmation taxes (except for most taxes for individuals), including state taxes that are not included under their plan of reorganization.
- The debtor obtains relief from creditor harassment while staying in business; is allowed to file a plan of reorganization to implement a means of paying off his or her pre-petition and administrative expense debt. It should be emphasized, however, that post-petition taxes are required to be paid on an on-going basis.
- The debtor must remit all post-petition taxes.

### **Chapter 12**

- Available to family farmers with annual income. May include a corporation or partnership if over 50% of it is owned by farmers.

## Chapter 13 - Debt Adjustment

- Available to individuals with regular income only (includes a husband and wife). It may include a business operated as a sole proprietorship.
- Includes limit on debts (\$100,000 unsecured; \$350,000 secured debt). Under proposed legislation currently before congress, these limits will be raised.
- Provides a "super" discharge of all debts provided for by the plan upon completion by the debtor of all payments within three to five years (usually five).
- Provides a hardship discharge if debtor cannot, for reasons for which the debtor should not be held accountable, make payments under the plan. This hardship discharge does not apply to most taxes.
- Allows debtor to orderly pay off his or her debts without harassment from creditors.
- Allows debtor to pay off debts under a plan in small amounts for three to five years without interest.

## Large Corporations in Bankruptcy

If a large corporation files for a Chapter 11 Reorganization, perform an audit unless one was recently completed. Also, protective claims for corporation excise taxes should be filed for all pre-petition and post confirmation periods if Audit has reason to believe the IRS is or may be conducting an audit that may result in **"federal change"** liability. Any audit should be scheduled and conducted as soon as possible after filing. Ninety days after the bankruptcy is filed a bar date for claims may be set. Keep in very close contact with the Bankruptcy Unit and the Litigation Bureau to be sure that the claim based on the audit is timely filed with the court. If the taxpayer is uncooperative, the Bankruptcy Unit, through the Litigation Bureau, might want to submit a motion to the bankruptcy court for a turnover of the records or for an extension of time to file a claim. Also, if necessary, an estimated audit should be performed and amended at a later date after discussion with the Bankruptcy Unit and the Litigation Bureau.

Income taxes withheld from employees and sales taxes collected prior to the bankruptcy filing are considered "trust fund" taxes. The court will be petitioned for immediate payment of these taxes.

## Insolvent Taxpayers

Insolvency is the inability to pay debts as they fall due in the usual course of business and/or having liabilities in excess of a reasonable market value of assets held, or insufficient assets to pay all debts.

A claim for insolvency should not be confused with imminent or actual bankruptcy. The insolvent taxpayer is either committed to paying his or her debts without seeking the legal relief available to the taxpayer in bankruptcy, or he or she is unable to afford legal fees to obtain protection under bankruptcy law. See the bankruptcy section of this chapter.

When insolvency is claimed, the Audit Division generally requires an examination of the records before making a recommendation. The Bureau Chief will issue a memo to the supervisor/manager requesting an insolvency investigation.

The investigation will verify the accuracy of the taxpayer's financial data by the given deadline and convey the findings to the Bureau Chief. The auditor's supervisor should also determine whether the audit should be expedited so that a jeopardy assessment can be issued. An immediate request for lien filing may be sent to the Collections Bureau.

Note: There are no set guidelines for determining when a jeopardy assessment should be issued. The auditor should obtain as much financial information about the taxpayer as possible and discuss the situation with the Supervisor/Manager or Director.

## **Sources of a Claim of Insolvency**

### **Audit in Progress**

The auditor may detect an unstable financial condition. The auditor should consult with the case supervisor/manager in deciding whether or not to continue the audit. If it is decided to continue the audit, consideration is to be given to statutory deadlines, scope of audit and the potential for audit adjustment and subsequent collection of a deficiency assessment.

### **Direct Contact**

The auditor should refer all taxpayers claiming insolvency to the Legal Division which will be primarily responsible for handling telephone and mail contact from taxpayers claiming insolvency outside of audits in progress.

## **Performance of the Review**

### **Objectives**

Ascertain that the taxpayer's financial condition, as reflected on his books and records, has not been the result of intentional or not intentional falsified financial data. The major objectives for implementing a review include:

- Confirming balances of financial statements;
- Determining that the financial data submitted by the taxpayer is in accordance with GAAP and that usage is consistent;
- Confirming all transactions and balances as bona fide;
- Verifying the existence and ownership of all assets;
- Verifying that expenses and liabilities are not overstated; and
- Verifying that income and expenses are not understated.

In most instances, the taxpayer is a proprietorship, partnership and/or closely held corporation. The records maintained by these taxpayers often represent un-audited financial data. Scrutinize all audit evidence for reliability.

## Basic Plan

The following outline is a basic plan in the overall examination of a taxpayer's books and records. Additional procedures unique to the specific audit and adapted to the size and nature of a taxpayer's business may be needed.

- Review the taxpayer's system of internal control.
- Analyze and review the general ledger.
  - Compare general ledger balances with financial statement balances.
  - Scan account entries.
  - Test account balances.
  - Trace postings from sub ledgers and general journal
- Analyze and review the subsidiary ledgers.
  - Obtain trial balances of asset accounts.
  - Foot trial balances and compare to controlling accounts.
  - Compare trial balance of Accounts Receivable with individual account balances in the subsidiary ledger.
- Examine books of original entry.
- Obtain external evidence if necessary.
  - Confirm accounts receivable.
  - Confirm bank accounts.
  - Inspect inventory.
  - Inspect other assets.
- Make overall inquiries of accounting policies.
  - Depreciation policy.
  - Credit policy.
  - Basis of accounting.
- Review financial statements and accounting principles.
- Make an overall evaluation of the financial conditions by applying tests of the appropriate ratios.

## TEST 1

### CURRENT RATIO

$$\frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{(\text{Cash} + \text{Acct. Recv.} + \text{Inventory})}{(\text{Acct. Payable} + \text{Fed. Inc. Tax. Payable} + \text{Misc. Acct. Payable})}$$

## **TEST 2**

### ACID TEST RATION

Cash + Net Receivables + Current Marketable Securities

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Current Liabilities

## **TEST 3**

### ACCOUNTS RECEIVABLE TURNOVER

Net Credit Sales

---

Average Balance of Trade Accounts Receivable

## **TEST 4**

### INVENTORY TURNOVERS

Annual Cost of Goods Sold

---

Average Inventory

## **TEST 5**

### AVERAGE # OF DAYS SALES IN ENDING INVENTORY

Ending Inventory X 365 Days

---

Cost of Goods Sold

## **TEST 6**

### DEBT TO EQUITY RATIO

Total Debt

---

Total Stockholders' Equity

In analyzing these ratios, consider several factors. Generally, from a creditor's point of view, the higher the current and acid-test ratios and the shorter the operating cycle, the

better. However, excessive current and acid-test ratios are unfavorable in management's view.

Similarly, an unusually high rate of inventory turnover may indicate that the company is losing business by failing to maintain an adequate supply of goods, but a creditor may look favorably upon a high turnover rate.

A high rate of accounts receivable turnover may indicate that the company's credit policies need to be relaxed to encourage more business, while a low debt to equity ratio may indicate a substantial margin of protection against insolvency.

For the purposes of determining the solvency or insolvency of the taxpayer, a comparison of ratios over time is more revealing than studying single measurements. A stable position or a degenerating financial condition may be revealed by analyzing the trends. However, do not rely solely on these ratios to determine solvency or insolvency. If the trend is favorable or unfavorable, make further inquiry as to the underlying reasons.

## **Fraud**

The statutory authority for assessment of a tax due to fraud is contained in MGL 62C, section 26(d) and section 28. Chapter 62C, section 26(d) provides that...in the case of a false or fraudulent return filed with intent to evade a tax or a failure to file a return, the Commissioner may make an assessment at any time, without giving notice of his intention to assess, determining the tax due according to his best information and belief.

Chapter 62C, section 28 provides that...if a person has filed a false or fraudulent return or has filed a return with a willful attempt in any manner to defeat or evade the tax, the Commissioner may determine the tax due, according to his best information and belief, and may assess the same as no more than double the amount so determined, which additional tax shall be in addition to the other penalties provided by this Chapter.

Every auditor in the Audit Division is responsible for the early recognition and timely referral of potential tax evasion cases to the Criminal Investigations Unit (CIU).

The mission of CIU is to gather and develop information establishing the commission of a tax crime. CIU investigates all types of tax crimes. Once developed, the cases are referred to the Attorney General for prosecution.

Taxpayer interviews and books and records verification provide opportunities to detect potential tax fraud or tax evasion schemes warranting referral to the Criminal Investigations Unit.

In order to assert fraud, actual fraud must be present. Actual fraud is defined as:

**"...deceit, trickery; specifically deception intentionally practiced to induce another to part with property or to surrender some legal right..."**

In tax matters, fraud is present where there is the integration of these important factors:

- Taxpayer pays less tax than what is due;
- Taxpayer deliberately and intentionally remits less tax; this is not due to an honest error or a misunderstanding of taxability; and
- The ends are achieved by the deliberate and intentional action of the taxpayer.

To successfully prove fraud, it is necessary to establish that a part of the deficiency is due to a false representation of facts by the taxpayer and that the taxpayer had knowledge of the falsity and intended that it be acted upon as truth.

The assertion of fraud must be supported by clear and convincing evidence and not rest merely upon suspicion or presumption.

Factors to be considered:

- The responsibility for the actions can be attributed only to the taxpayer and not blamed on another;
- The circumstances are flagrant in nature and were intended to reduce the tax liability through deception or falsification;
- The amount of tax deficiency caused by the fraudulent activity is material with respect to the total tax liability; and
- The evidence of fraud is available and obtainable.

A fraud situation exists most often for cases in which tax collected is not remitted. A pattern can usually be found, such as:

- Duplicate invoice numbers with different names;
- Erasures in journals and ledgers;
- Invoices do not match journals/ledgers;
- Figures do not trace through the accounting system, especially through to bank records, which are externally generated;
- Information or an admission obtained from an employee, especially a bookkeeper;
- Vendor records/customer records that do not match source documents;
- External records such as affidavits, court records, etc., that do not match source documents; and/or
- Changing names on collected invoices to names of exempt customers (and erasing the tax).

There are other fraudulent activities besides tax collected but not remitted such as falsifying motor vehicle trade-in values, etc.

## **Criminal Fraud vs. Civil Fraud**

The basic elements are the same. The difference is in the degree of action or inaction. In civil fraud, the degree of proof necessary is that the evidence must be clear and convincing that the taxpayer acted with willful intent to defeat or evade the tax. In criminal fraud, the degree of proof necessary is that the evidence that must show beyond a reasonable doubt that a taxpayer acted willfully with intent to evade or defeat the tax. This evidence is based on normal knowledge in everyday life and not on the knowledge of an expert.

The Criminal Investigations Unit (CIU) of the Litigation Bureau housed within the Legal Division is responsible for investigating potential criminal tax fraud cases based on referrals made to the Fraud Referral Coordinator (FRC) within the unit.

The Civil Fraud Unit is part of the Desk Examination Unit, Bureau of Desk Audit, within the Audit Division. This unit handles established criteria for Earned Income Credit (EIC) issues and Fraud Detection.

## **Burden of Proof**

The state has the burden of proof in upholding a civil fraud assessment, which means the auditor must document with clear and convincing proof showing the taxpayer's guilt. Documentation includes but is not limited to copies of exceptions, written details of the exceptions, a listing of events that led to the scheduling of exceptions and the reasons the exceptions are considered to be fraudulent.

The Attorney General's office prosecutes tax crimes on behalf of the Commonwealth. The Department of Revenue must prove an element of a tax crime charge that the taxpayer's conduct was willful by demonstrating that the taxpayer's actions constituting fraud or evasion were part of a pattern of activity sufficient to overcome the explanations of negligence or awareness.

## **Procedures for Recommending a Referral**

When indications of fraud are discovered during the course of an audit, the auditor will gather as much evidence as necessary to document the fraud pattern.

The auditor should contact his/her supervisor for additional guidance in obtaining necessary evidence. When sufficient information has been gathered, an Audit Referral Form CIU-1 should be completed. The auditor should also prepare a memo detailing the events that explain the documentation and the auditor's position. The auditor must send these documents, through his/her Director and Bureau Chief for transmittal to CIU.

Once the audit has been referred for possible investigation for criminal charges, the auditor should not proceed with the audit until instructed to do so by the Criminal Investigator assigned or the Fraud Referral Coordinator. The auditor will not hold an exit

conference with the taxpayer unless instructed to by CIU. If the taxpayer has any questions about the audit, the auditor will refer the taxpayer to the assigned Criminal Investigator, or the Fraud Referral Coordinator, and will not discuss the audit.

## **Application of Civil Fraud**

To successfully sustain a civil fraud assessment, it is necessary to establish, in detail, that a part of the deficiency is due to the misrepresentation of facts by the taxpayer and that there was knowledge of the falsity and that the falsity be acted upon as truth. The evidence must include the actual documents or exact copies of the documents or information.

If an auditor determines the existence of a pattern of non-reporting or under reporting of tax with intent to defraud the Commonwealth, he/she should immediately discuss findings with his/her supervisor/manager and initiate the following course of action:

- Suspend audit as soon as sufficient information has been obtained to document a CIU referral.
- Discontinue all taxpayer contact after you and your supervisor have determined that there is sufficient data to warrant a referral to CIU.
- Promptly fill out a CIU Referral Report (Form CIU-1).

After compiling the audit case file containing the completed referral form, copies of source documents and all original work papers, the case is reviewed by the Manager/Director to assure that the facts and documentation supports a potential fraud case.

The Manager/Director will examine the case and concentrate on the following areas of the referral:

- The books and records examined by the auditor and documents maintained by the taxpayer;
- Documentation to support suspicion of fraud;
- No issuance of NIA or soliciting returns;
- No advice and direction from CIU on the actual case;
- The referral meets the criteria of willful tax violation(s);
- Written details of the taxpayer's explanation for potential criminal behavior, i.e., failure to file, failure to pay or under reporting.

If the Manager/Director agrees that the case should be referred to CIU, the Manager/Director will send the case to the Bureau Chief on a transmittal form and add a case flag to AWB-Case Summary to alert users that the case was transferred to CIU. The Manager/Director can easily enter a description of the case or date the case was transferred to the Bureau Chief to be forwarded to CIU in the note text box.

The Manager/Director is responsible for protecting the Statute of Limitations for assessment and the monitoring of the open case while in CIU's custody.

## **Auditor Responsibility**

When an audit has been accepted for criminal investigation, the auditor may still have to spend some additional time working with the investigator. The responsibility of the auditor includes any examination of additional records obtained during the investigation, explaining audit schedules and audit procedures to the investigator. The auditor must keep his/her supervisor fully informed as to the requests made by the investigator of the auditor's time.

## **Application of Criminal Fraud**

The successful prosecution of tax law violators is important to the fair and uniform administration of state tax law. All Department personnel share in the responsibility of identifying tax fraud.

Revenue fraud may be depicted in a variety of ways. The most obvious is the failure to file a return, but many schemes are initiated to either understate income or to overstate expenses. "Badges of Fraud" are used as indicators and should raise the question of potential criminal fraud or evasion in the mind of the auditor.

Examples are: omissions of specific items of income where similar items were reported in the past, false or misleading statements, large currency transactions, failure to file returns for several years although substantial taxable income was received, maintaining a double set of records or no records, loose internal controls of cash receipts, false entries in books or alteration of records, the destruction of books or records including records lost from fire, theft or flood, a substantial net worth increase incommensurate with reported income, excessive personal expenditures, unexplained bank deposits, false or overstated deductions or exemptions, substantial understatement of income over a number of years, unusual handling of business receipts such as the failure to deposit checks received as receipts to the business bank account or the cashing of those checks and any conduct which would likely have the effect to mislead someone or to conceal something.

## **Auditor Responsibility**

The potential for misuse of the criminal investigation by the Department through its extensive civil enforcement powers make the court and the Attorney General reluctant to entertain a case that has substantial disguised civil involvement. Simply put, we cannot conduct a criminal investigation under the guise of a civil examination.

When an audit has been identified as a potential fraud referral, the tax auditor can adversely affect the prosecution potential of a case in three principal ways:

1. By soliciting an agreement to proposed tax increases including the issuance of an NIA;
2. Soliciting and actually receiving a delinquent tax return; or

3. Obtaining advice and direction from CIU concerning a specific case prior to the making and accepting of a criminal referral.

When suspicion of fraud or evasion arises in an auditor's mind, he/she should write the results of his contact with the taxpayer and/or taxpayer's representative which should be incorporated into the AWB-Case Log. Any future contact should be maintained in written form as well. Important items to note are dates and admissions of the taxpayer regarding the existence of records for the periods involved and their custodian. Also, any altered bookkeeping, accounting records maintenance procedure, false or misleading statements and any general statements made or actions taken by the taxpayer which would assist CIU in evaluating the intent to evade taxation.

# Chapter 7

## Sales/Use Tax Auditing Procedures

### Introduction

The primary purpose of the sales/use tax audit is to confirm that the taxpayer has reported the correct amount of tax. Reported amounts on the sales tax history must be analyzed when examining the taxpayer's records as well as its purchases for resale and non-exempt use.

### Sales Tax

In accordance with M.G.L. Chapter 64H, Massachusetts imposes a 6.25% sales tax on the sales price or rental charge on tangible personal property or certain telecommunication services sold or rented in the Commonwealth. The sales tax is paid to the vendor in addition to the sales or selling price. The buyer pays sales tax to the vendor of tangible personal property; then the vendor remits the tax to the Commonwealth. (See M.G.L. Chapter 64H, section 1 for additional information regarding "sales", "sales price", "sale at retail", "services", "tangible personal property" and "telecommunication services", etc.).

**Note:** For motor vehicle and trailer sales, the sales tax is paid directly to the Commonwealth by the purchaser. (See CMR 64H.25.1).

### Use Tax

In accordance with M.G.L. Chapter 64I, Massachusetts imposes a 6.25% use tax on the sales price or rental charge on tangible personal property, including mail order items or items purchased via the Internet, or certain telecommunication services where no sales tax, or a sales tax rate less than the 6.25% Massachusetts rate was paid, which are to be used, stored or consumed in Massachusetts. In general, the use tax is paid directly to the Commonwealth by the purchaser. (See M.G.L. Chapter 64I, section 1 for additional information regarding "purchase and purchased", "purchaser", "store", "storage", and "use", etc.).

### Administrative Details

#### Identifying Responsible Person(s)

In order to facilitate the collection of tax liabilities imposed on corporations and partnerships by MGL chapters 62B, 64G, 64H and 64I, auditors must identify the responsible person(s) who are liable for such trustee taxes pursuant to M.G.L. Chapter 62C, section 31A and 830 CMR 62C.31A.1.

The identification of responsible persons must be done for all trustee tax audits. Auditors must document in the audit narrative and Audit WorkBench (AWB)-Case Log the names of the individual(s) responsible for paying over the trustee taxes. This information must also be entered into the MASSTAX system under the taxpayer "note" screen.

### **Bank Account Information**

During the course of the examination, the auditor must gather the following information relating to the taxpayer's banking activity:

- Name of bank(s) in which the taxpayer has account(s); and
- Account(s) numbers.

If the taxpayer has more than three (3) accounts, the auditor must get the above information for the taxpayer's three primary accounts. The information must be noted in the audit narrative and documented in the MASSTAX system under the taxpayer "NOTE" screen.

### **Bankruptcy Information**

When a taxpayer files the bankruptcy case, the automatic stay prohibits all of the taxpayer's creditors, including the Department of Revenue, from taking any action to collect any debts or liabilities that relate to the time period before the Petition Date. During the course of the initial taxpayer contact, the auditor should ask the taxpayer if they are in bankruptcy. If the taxpayer is in bankruptcy, the auditor must obtain the following information and forward it to the Litigation Bureau's Bankruptcy Unit immediately:

- The location of the Bankruptcy Court;
- The Bankruptcy Court docket number (stamped on the bankruptcy petition); and
- The petition date (the date the bankruptcy case was filed).

The information must be noted in the audit narrative and Audit WorkBench (AWB) - Case Log to ensure the necessary steps are taken to contact the Bankruptcy Unit in a timely fashion.

**Note: Bankruptcy procedures are discussed in detail within Chapter 6-Specialized Audit Procedures of the Field Audit Procedures Manual.**

### **Case Plan**

The Audit WorkBench (AWB)-Case Plan will be used to guide the progression of each case. The case plan is structured to allow for flexibility of workflow and is broken into primary tasks and subtasks. When all of the subtasks are completed within a certain

primary task, it will automatically be recorded in Audit WorkBench-Case Log.

The Primary Tasks are as follows:

- Pre-Audit Analysis:
  - The steps involved in completing this Primary task entail documenting the source of audit and audit period;
  - Prepare the taxpayer history and review the applicable prior audit reports;
  - Research the taxpayer's website on the internet;
  - Discuss the audit plan with the supervisor/manager;
  - Contact taxpayer by telephone to schedule an opening conference;
  - Issue the confirmation letter and checklist/document information request through Audit WorkBench-Notice Generation.
- Initial Audit Review:
  - Within the New England Audit Bureau, the opening conference is conducted with the supervisor, auditor and taxpayer to discuss the audit parameters communicating the Taxpayer's Bill of Rights, conduct a tour of the facility, ascertain any prior audit information availability, obtain the necessary Power-of-Attorney Form M-2848 and/or obtain an executed Consent for Extending the Time for Assessment, Form A-37 (if applicable);
  - Within the Multistate Audit Bureau, the opening conference is conducted with the auditor and taxpayer to discuss the audit parameters communicating the Taxpayer's Bill of Rights, conduct a tour of the facility, ascertain any prior audit information availability, obtain the necessary Power-of-Attorney Form M-2848 and/or obtain an executed
  - Consent for Extending the Time for Assessment, Form A-37 (if applicable);
  - Determine the account, periods and populations to be tested or reviewed in their entirety, applicable to transaction taxes only;
  - Discuss the availability of electronic records and/or the merits of conducting the audit using Computer Assisted Auditing Techniques (CAATs), applicable to transaction taxes only;
  - Document the reasons for the selection of the test periods;
  - Issue appropriate Audit Division forms.
- Audit Review and Documentation:
  - Reconcile and analyze the taxpayer's books and records including the transaction tax returns, sales journals, general ledgers, Massachusetts state tax returns, federal tax returns and supporting schedules, apportionment work papers, 10K reports, financial statements and other

records of the taxpayer and prepare comparative schedules to determine the accuracy of the records and document if any adjustments are required;

- Examine the taxpayer's records including sales, fixed assets, expenses, other applicable categories, document all exceptions to support the audit findings and issue the 60-day Notice of Exceptions to the taxpayer for invalid or missing exemption certificates\*, applicable to transaction taxes only;
  - Determine, research and resolve legal and/or policy issues with management;
  - Provide the taxpayer with copies of the preliminary audit work papers which are pending review by the supervisor or manager and are subject to change.
- Findings and Reporting - Supervisory Review and Exit Conference Procedures:

#### **A. New England Audit Bureau**

- Review the audit with the supervisor prior to the exit conference and discuss any unresolved issues;
- Conduct the exit conference with the taxpayer, review the auditor's findings and provide statutory citations, case law and DOR pronouncements to support the audit adjustment including error factor and projection calculations;
- Include the Exit Conference Report prepared by the supervisor/manager in the electronic audit case folder;
- Document the final results for review and approval by the supervisor/manager including all pertinent information and documents scanned and attached to the electronic audit case folder;
- Prepare applicable audit referrals and scan and attach documents to be forwarded to the appropriate bureaus by the supervisor/manager via electronic means;
- Key the assessment into Audit WorkBench-Assessments, allocate the audit issues and auditor credit, prepare the Notice of Intention to Assess (NIA) through the Interface Details link, validate the assessment and seek case approval based on dollar threshold;
- The supervisor/manager prepares and sends the Exit Conference Letter to the taxpayer or representative along with Forms B-37 and DR-1 explaining the audit findings and informing the taxpayer of their appeal rights and attach the letter to the electronic audit case folder;
- The supervisor/manager interfaces the assessment to issue the NIA upon final management approval of the case in Audit WorkBench(AWB); and
- If requested, the supervisor/manager prepares the case file for the Office of Appeals (OOA) which includes executing Form B-37, updating the SOL date to 12/25/2027 on Audit WorkBench(AWB)-Period Details, scanning and attaching Forms B-37 and DR-1 to ready the electronic audit case folder for OOA.

## **B. Multistate Audit Bureau**

Based upon logistics, the Multistate Audit Bureau presents findings to a taxpayer via a process involving a "10-day Letter" after the auditor submits the completed electronic audit case file for supervisory review. The "10-day Letter" is accompanied by copies of work papers which have been reviewed and approved by the manager. It provides the taxpayer with concise written explanations of the adjustments. The letter affords the taxpayer a period of ten days to review the work papers and then decide whether, at its option, it wishes to have an exit conference. Within Multistate, exit conferences may be in person or via the telephone. Alternatively, a taxpayer may submit its position in writing along with supporting documentation for consideration. Once the exit conference is held:

- Document the final results for review and approval by the supervisor/manager including all pertinent information and documents scanned and attached to the electronic audit case folder;
- Prepare applicable audit referrals and scan and attach documents to be forwarded to the appropriate bureaus by the supervisor/manager via electronic means;
- Key the assessment into Audit WorkBench-Assessments, allocate the audit issues and auditor credit, prepare the Notice of Intention to Assess (NIA) through the Interface Details link, validate the assessment and seek case approval based on dollar threshold;
- The supervisor/manager prepares and sends the Exit Conference Letter to the taxpayer or representative along with Forms B-37 and DR-1 explaining the audit findings and informing the taxpayer of their appeal rights and attach the letter to the electronic audit case folder;
- The supervisor/manager interfaces the assessment to issue the NIA upon final management approval of the case in Audit WorkBench(AWB); and
- If requested, the supervisor/manager prepares the case file for the Office of Appeals (OOA) which includes executing Form B-37, updating the SOL date to 12/25/2027 on Audit WorkBench(AWB)-Period Details, scanning and attaching Forms B-37 and DR-1 to ready the electronic audit case folder for OOA.

## **Opening Conference - Additional Topics to Be Covered in a Sales/Use Tax Audit**

A field audit begins with an opening conference. In addition, the auditor is expected to secure additional detail about the taxpayer that will be used to conduct the audit more efficiently and identify issues for review. Prior to the opening conference, the auditor will prepare a list of questions to be addressed to obtain an overview of the entire operation of the business and also identify probable problem areas of tax liability or credit prompting the auditor to raise additional questions when appropriate during the interview. For example, the taxpayer or taxpayer's representative should be asked to explain or provide the following:

- The reporting method utilized.
- The step-by-step process by which the information is obtained and summarized to prepare the return. (This information includes the records used to prepare the return.)
- Any work papers used to prepare the return. (These should be checked for completeness and whether they include all areas subject to tax.)
- General Ledger accounts that have been used by the taxpayer in reporting. (Check for related accounts when the Chart of Accounts is reviewed.)
- Changes in personnel who prepared the return. Obtain the name and position of anyone who prepares a specific portion of the return.
- Resale/exemption certificates for tax-free sales.
- Items included in deductions and taxable purchase.
- Unusual areas (i.e., changes in reporting method, etc.).
- If the reporting method has been changed, check the different methods used and document the changes in the Audit WorkBench (AWB)-Case Log.
- What items the taxpayer is claiming as deductions.
- All categories of revenue, sales of equipment, parts, labor, services, consulting.
- Billing & collection procedures for all sources of revenue through the accounting system; including cash and charge sales, credits, shipments and destinations.
- The self-assessment or the accrued tax liability procedures.
- Purchasing procedure for inventory, supplies, expenses and fixed assets.
- Accounts payable process including receiving and approving for payment, account distribution, returns, checks and remittance advice.

As soon as practical after completion of the opening conference, the auditor should schedule a tour of the taxpayer's facility. This will frequently identify other issues to be addressed during the audit. The auditor may dispense with the tour if it is not expected to be of value. If, as the audit progresses, the auditor determines that a tour would be relevant; it should be requested in writing.

Both the opening conference and the tour (or the decision to forego the tour) must be documented in the Audit WorkBench (AWB)-Case Log.

### **Analyze Reporting Categories**

Reporting categories are broken out as follows on the sales tax return in WebFile for Business (WFB):

1. Gross Sales
2. Sales for resale/exempt sales or other adjustments
  - 2A. Sales of materials, tools and fuel
  - 2B. Sales of machinery and replacement parts
3. Total non-taxable sales (sum of 2, 2A and 2B)
4. Taxable sales (line 1 minus line 3)
5. Use tax purchases
6. Total taxable amount (sum of line 4 and line 5)

Audit procedures used in each audit situation will be adapted to the individual taxpayer's system of accounting and record keeping. Since different reporting methods are used by taxpayers to complete sales tax returns, it is important that the auditor understand the method utilized by the taxpayer. The auditor should complete an analysis of the accounting system and devise specific audit procedures applicable to the audit. Certain procedures must be performed on each audit (i.e., tax reconciliation, gross sales reconciliation, examination of purchases, etc.).

## **Preliminary Audit Review**

### **Common Reporting Methods**

The common methods frequently used by taxpayers for reporting sales tax are:

- Reporting taxable sales only;
- Determining taxable sales by backing into taxable sales by dividing tax billed by the tax rate or tax collected by the tax rate;

Reporting gross sales and determining deductions by backing into taxable sales; and Reporting Massachusetts's destination sales only and determining deductions by backing into taxable sales.

Any of the above methods plus any other method employed must be audited to verify gross sales, sales subject to Massachusetts's sales tax and deductions qualifying as exempt sales.

## **Review of Internal Controls**

The taxpayer's system of internal control must be analyzed and evaluated to determine the reliability of the records being examined. The depth of the audit examination is determined in great part by the reliability of the taxpayer's internal control system.

### **Characteristics of Good Internal Controls**

Some characteristics of good internal controls are listed below. Each system must be analyzed for specific strengths and weaknesses.

- A clearly defined separation of responsibility for each function;
- An adequate system of authorization;
- Adequate supervision of duties;
- Adequate documentation;
- Adequate protective measures (i.e., locked rooms for inventory, etc.);
- Segregation of duties;
- Internal audit verification system;
- Operating Procedures Manual; and

- Outside verification (Public Acct. Firm) audited and prepared financial statements.

## **Total Sales**

Total sales consist of all taxable and nontaxable sales made during the reporting period. Sales tax collected should not be included in reported total sales.

## **Internal Controls**

Generally, verification of total sales includes:

- Reviewing the Chart of Accounts for revenue accounts;
- Reviewing the taxpayer's method of reporting sales;
- Reconciling recorded and reported amounts;
- Determining which accounts make up total sales;
- Determining how cash sales are handled;
- Determining how credit sales are handled;
- Determining how bad debts are handled; and
- Reviewing method of billing all shipments and other revenues.

## **Reconciliation of Recorded and Reported Sales**

Reconciliation should be performed by comparing reported sales (per the sales tax return) with audited sales (per books and records). This reconciliation may be completed by report period or by year. **Taxable and non-taxable** transactions should be reviewed.

Reported total sales should also be compared to:

- Federal Income Tax Returns
- Massachusetts Personal Income (Schedule C)
- Financial Statements
- Mass. Corporate Excise (Schedule F)

Any differences found between reported and audited sales should be analyzed considering the taxpayer's reporting method. Determine if the differences result from taxable or nontaxable sales. Audit adjustments should be made for unreported taxable sales.

If no differences are noted, then document this fact in the Audit WorkBench (AWB)-Case Log.

## **Preliminary Review of Taxpayer Records**

Preliminary reviews should be done before a thorough examination of records is performed. This review will provide the necessary information to determine whether to perform a detailed audit or to employ sampling procedures. Highlight key areas that may need a more detailed examination. Before relying on taxpayers' records, conduct a review of the following:

- Testing one or two reports to verify that the procedures as explained are used to prepare the return;
- Postings in sales journals to general ledgers;
- Recording of daily sales totals or invoices to sales journals;
- Sales journals footings (totals);
- Unusual entries in journals and ledgers; and
- Recording accuracy, records flow, tax charged and rate of tax.

If the preliminary review reveals that summary records accurately reflect the taxpayer's method of accounting, then use the taxpayer's summary records. If not, then an examination of the original source document may be necessary. Document your findings in Audit WorkBench (AWB)-Case Log.

## **Sales/Use Tax Audits Procedures**

The use of sampling techniques represents an effective method by which the Commissioner of Revenue may carry out the duty of tax administration. The use of sampling can contribute significantly to the overall goals of maximizing audit coverage and encouraging proper reporting practices. These goals, which benefit all Massachusetts' taxpayers, must be balanced by careful analysis and planning.

The Commissioner of Revenue has statutory authority to conduct sample audits. Massachusetts General Law, Chapter 62C, section 24 defines this authority:

If the books, papers, records and other data of the taxpayer are so voluminous as to make a complete audit thereof impractical and inefficient, the commissioner may use such statistical sample methods in conducting such audit as may be agreed to by the parties and project the audit findings derived there from over the entire audit period to determine the proper tax. If, after a good faith effort, the parties cannot reach such an agreement, the commissioner may utilize such statistical sample methods, which he deems appropriate and which comply with the provisions of the Internal Revenue Code.

Computer Assisted Auditing Techniques (CAATS) is a way to streamline the audit process by completing an efficient, understandable and accurate audit through the use of electronic records where statistical sampling validates the transaction base and provides a clear audit trail needed to determine the proper tax due or to propose adjustments to tax reported. CAATS is the preferred method for sampling. If CAATS is not to be used for sales or expenses, the auditor should make a note in the Audit

WorkBench (AWB)-Case Log and narrative as to the reasons for not using CAATS (e.g. different accounting systems used throughout the audit period, paper records, etc.) All medium sized and larger taxpayers should be requested to complete and return the CAATS Questionnaire.

Whenever possible, the Audit Division will employ the use of ACL software to conduct a statistical sample of the records as found in "A Guide to Computer Assisted Auditing Techniques" located on the Department of Revenue's website at [www.dor.state.ma.us](http://www.dor.state.ma.us).

Block Sampling is another way, which allows the auditor to choose only those areas of a taxpayer's business, which would most apt to be subject to the imposition of either a sales tax or on the purchase side a use tax. The goal of testing or sampling is to determine the level of tax compliance for a taxpayer by identifying transactions in which non-compliance exists during certain test period (s) within the entire period. Test sampling requires a certain level of standardization, but must also maintain a degree of flexibility due to the uniqueness of each taxpayer's record-keeping and overall accounting system. Electronic records are encouraged to facilitate the data entry process. As such, auditors should request records in electronic format whenever possible, and should note such requests in the Audit WorkBench (AWB)-Case Log.

### **General Policies and Procedures on Sampling**

The following general policies regarding sampling have been established by the Audit Division and should be used in the conduct of tax audits as required:

- Written notification of the sampling procedures will be given to the taxpayer when it is first determined that sampling will be conducted.
- The notification will be hand delivered whenever possible (otherwise, mailed) and must be given or sent to the person designated by the taxpayer to make decisions regarding the conduct of the audit.
- All notifications given to the taxpayer will be stored in the electronic audit case folder in Audit WorkBench (AWB)-History.
- Upon reaching agreement on sampling procedures, the taxpayer and auditor will execute a written agreement to use a representative test.
- If, after a good faith effort, the parties do not reach an agreement to use a representative test, the auditor, after notifying the taxpayer in writing, may perform a representative test using those methods that are reasonably calculated to reflect taxes due the Commonwealth.
- Sampling will be considered for use in every audit situation where the conditions of the business and records meet the criteria authorized by the statute.
- Asset purchases will be detailed unless the auditor has established that a consistent and recurring pattern of acquisition exists.

## **The Sampling Process**

Each step in the sampling process involves a choice of several alternatives. As the sampling plan is being developed, it is important to keep the steps in mind. Broadly stated, these steps are:

- Define the population to be audited.
- Determine appropriate stratification of the population such that the strata are relatively homogenous populations;
- Choose the type of sampling unit;
- Determine the sample size;
- Establish correspondence;
- Select the sample units;
- Perform a preliminary sample examination;
- Complete the sample examination;
- Evaluate the sample results; and
- Project the results to the population.

## **Sampling - Preliminary Testing**

These tests are undertaken for the purpose of determining the overall accuracy and completeness of the taxpayer's reporting system and the existence of good internal controls. Areas to be tested in the initial stage are the systems for reporting gross sales and the system for reporting use tax.

- Are all sales properly reported on a Massachusetts destinations basis?
- Are the deductions accounted with properly supported resale certificates (Form ST-4), exempt use certificates (Form ST- 12), exempt purchase certificate (Form ST-5C), etc.?
- Other adjustments such as return of property within 90 days from the date of sale?
- Is property purchased from non-registered vendors properly accrued and timely reported for use tax purposes?
- Is property purchased with an exempt use status proper?
- Is property purchased originally exempt later used by the company in a taxable manner?

## **Notice Requirement**

Audit Division policy requires that written notification be given to taxpayers of the sampling procedures to be used in the conduct on an audit prior to utilizing a sample technique to determine the proper amount of tax.

The notice should include sufficient detail for the taxpayer to fully understand the sampling procedures. This usually requires a general reference to the methodology and specific references to the taxpayer's unique circumstances. When all parties agree to

the sampling procedures, Agreement to Use Representative Test should be presented to the taxpayer for signature and documented in the Audit WorkBench (AWB)-Case Log. The auditor must remember to issue a separate Agreement to Use Representative Test for each examination where the findings will be projected. All notices generated will be recorded in Audit WorkBench (AWB)-History, which stores an exact image of the notice sent to the taxpayer. The notice can be viewed, but cannot be edited to maintain the integrity of the document.

The Notification of Sampling and Representative Test Agreements for Block and CAATS sampling are referenced below.

## **Detailed Procedures For The Audit of Sales**

### **General Ledgers**

Examine general ledger accounts for debits and credits that may represent unreported taxable sales such as:

- Sales of merchandise at cost credited to purchase or inventory accounts;
- Sales of by-products credited directly to profit and loss, surplus or expense accounts; and
- Sales of furniture, equipment or other capital assets credited to equipment, depreciation, gain or loss or other accounts. In general, this is a casual and isolated sale unless the taxpayer is regularly engaged in selling fixed assets "leasing company" (See Regulation 830 CMR 64H.6.1).

Account for all sources of revenue:

- Review the taxpayer's Trial Balance for audit periods;
- Compare Trial Balance figures to Massachusetts personal income/corporate excise return;
- Compare Federal Return to Trial Balance;
- Review Chart of Accounts for any additional questionable sales or revenue accounts;
- Inquire if taxpayer engages in e-commerce (internet sales) in which no sales invoices are generated;
- Determine how activity is tracked and reported;
- Identify all categories of sales that are subject to tax and reconcile to gross revenue; and
- Verify taxable sales and identify and list deficiencies.

In the case of large multistate corporations, auditors should determine the feasibility and materiality of performing these tasks prior to applying these procedures.

## **General Journals**

Examine the general journal and note entries that may indicate unreported taxable sales.

Consider all data pertaining to general journal entries in determining if an entry represents an unreported taxable sale. This data may include:

- Correspondence
- Contracts
- Invoices and other documents

## **Cash Receipt Journal**

Examine the cash receipts records to determine whether receipts from cash sales have been credited to the proper sales or revenue accounts. Be careful not to duplicate taxable sales found in other records. Verify postings to accounts receivable account.

- Prepare a Bank Deposit Analysis to test the relationship between cash receipts and recorded gross receipts when dealing with companies selling mainly taxable items and/or those engaged in small retail operations. This step may not be possible for a large national/international entity.

## **Accounts Receivable Ledger**

Examine the accounts receivable from the owners, partners, officers or employees of a firm for evidence of taxable sales not otherwise recorded in the sales or revenue accounts. Examine partners' draw accounts and employees' advance accounts.

## **Purchase Journal**

Entries may be made in the purchase journal for sales at cost or returned merchandise. Inventory withdrawals that should have been reflected in the inventory accounts may also appear as credits in the purchase journal. Examine these postings for taxable sales because inventory withdrawals could be subject to a "use tax" or a "sales tax" depending upon whether an exemption certificate had been issued by the taxpayer to the vendor of the item (s). The auditor should fully explore this issue when items were purchased from a Massachusetts vendor. See MGL Chapter 64H, sections 8(d) and 8(h), and Chapter 64I, sections 8(e) and 8(j). Any assessments made based upon these sections should be cited in the free form comments section of the Notice of Intention to Assess (NIA), the supervisor's or manager's Exit Conference Letter and the audit work papers.

## Sales Invoices and Journals

Sales invoices are source documents and usually represent the original record of a transaction. It is a necessary part of audit procedure to examine a representative number of these invoices to determine:

- How the transactions are recorded on the invoices?
- How is labor billed and accounted for? Installation - fabrication and assembly?
- If tax was properly assessed, was tax properly recorded in journal?
- How are the invoices filed? By invoice number? By customer's name? By days? By months?
- How are deliveries made and billed?

### Invoices are used to verify:

- Postings
- Tax accruals
- Deductions
- Zero Invoices
- Types of transactions

**Postings:** Here is the first step in verifying the accuracy of the books of original entry. The sales invoice is traced directly to the sales or revenue journal for accuracy of posting relative to amount and classifications. Trace source documents through to summary records and check for errors and omissions.

### Determine if:

- They are consistent.
- There is a posting from each source for each month or accounting cycle.
- There are sources of postings that might reveal operations not disclosed in pre-audit research or discussions with the taxpayer.

**Tax Accruals:** The tax assessed on the invoice is important because the tax accrual amount is based on the tax rate times the taxable value. This information is especially important on audits of taxpayers that derive total sales, taxable sales or deductions based on the amount of tax accrued. The taxable sales should be determined by reporting proper gross sales and identifying exempt sales as a deduction from gross sales.

**Deductions:** Note what type of deductions the taxpayer is claiming because they may lead to a detail of certain accounts.

**Zero Invoices:** A zero invoice in many cases may indicate that the taxpayer is sending samples or tangible personal property to a customer free of charge or withdrawing

inventory for their own use. These should be reviewed just as a regular invoice. If the auditor determines that items are given away free of charge, or otherwise used for purposes other than resale, tax may be due on the cost of the property given away.

**Types of Transactions:** For the sale of tangible personal property or taxable telecommunication services, examine invoices to determine if charges are consistently separated or billed as a lump sum. This information is also important to know when examining purchases. If there is a lump sum charge that includes both taxable and nontaxable amounts, the entire charge is taxable unless the taxable amount is inconsequential. Otherwise, to be excluded from the taxable amount, the nontaxable items must be separately stated on the invoice or other billing document.

### **Federal Income Tax Return**

A comparison of gross receipts and other income reported for federal income tax purposes with state sales and use tax returns is a good audit practice. This comparison may be a difficult analysis to perform if the taxpayer files a consolidated federal income tax return. However, the taxpayer should have working papers showing how these figures were obtained.

Reconcile the differences between the reported figures. **Material differences should be analyzed.** Determine if the difference is the result of taxable versus nontaxable sales or Massachusetts and non-Massachusetts's sales. Also review Schedule D of the federal income tax return for any fixed asset sales.

In making this reconciliation, differences may be due to:

- Timing.
- Accounting basis (reporting on cash basis for income tax purposes and using an accrual basis for sales and use tax purposes or vice versa). An analysis should be made of the tax accrual or payable account to identify all sources of liability for taxes and the appropriate adjustments.

### **Sales Tax Verification**

Sales tax billed versus sales tax reported should be reconciled in detail for every audit. Total sales should not include tax billed but:

If a taxpayer does not separate tax and selling price (total sales figure includes tax), determine if:

- Total amounts (including tax), of sales invoices are included in the Gross Receipts when entered into the sales/revenue journal including exempt sales. Tax should be segregated and accounted for in a separate column and booked in the Liability Account through the Sales Journal.

- The price and tax rung up on the cash register is recorded in the Cash Receipts Journal. Massachusetts's sales tax should be separately stated.

Then determine total sales by:

- Reducing the total sales figures (tax included) by the amount of tax-exempt sale to arrive at total taxable sales (tax included).
- Dividing total taxable sales (tax included) by one plus the appropriate tax rate to arrive at total taxable sales (tax excluded).

Add total taxable sales (tax excluded) and tax-exempt sales to obtain a total sales figure.

### **Sales Tax Verification, Example**

The total amount of sales of ABC Company is entered in the cash receipts journal. The taxpayer also made exempt sales to a state agency, and these exempt sales were included in the cash receipts journal. Figures from the cash receipts journal show:

Total Sales (tax included)	\$ 13,281.25
Less: Exempt Sales	< 2,000>
Equals: Total Taxable Sales (tax included)	<u>11,281.25</u>
Total Taxable Sales (tax excluded)	
equals \$11,281.25	
divided by 1.0625	\$ 10,617.25
Add:	
Total Taxable Sales (tax excluded)	\$ 10,617.25
Plus: Exempt Sales	2,000.00
Equals: Gross Sales/Total Sales	<u>\$ 12,617.65</u>

Sales Tax Equals: \$663.60

### **Analyze Sales Tax Accrual Accounts**

Analyze the tax accrual account (also called sales tax payable account) by comparing tax accrued to tax reported for the audit period. If differences exist, determine the reason for the difference, and if necessary, prepare a schedule and make an adjustment in the audit. In instances of larger companies, they may not have a separate accrual account for Massachusetts, but one all-inclusive account. Taxpayers may use other tax software to track sales by states, such as Vertex Tax Software. This type of software does provide detail tax by state and all state taxes should tie to the tax accrual account.

Differences may occur due to:

- Other credits in the sales tax accrual account (i.e., discounts);
- Holding tax liability on large sales for verification;
- Returned merchandise sales for which credit memos have not been recorded in the sales journals and/or tax accrual account; or
- Tax on taxable purchases being posted to the tax accrual account. This would make it a sales & use tax accrual and included as a use tax on the return.

Verify that credits such as those mentioned above are properly taken and supported.

Note: If the taxpayer does not maintain a tax accrual account, examine available summary records.

### **Analyze Debit Entries**

Analyze debit entries to determine if:

- Excess tax is being written off to a miscellaneous income account;
- Debit entries exist for bad debts, discounts, returned merchandise and refund claims. In many instances, the debit entries are manual entries in which only tax is debited and there may be no activity reflected in the sales journal or reflected in gross sales. Verify tax refund claims to determine if the customers have received them or qualify for a refund. Bad Debt reimbursement claims must be filed on Form ST-BDR or ST-BDR-Meals for sales on meals based on their fiscal year for federal tax purposes after 1999 for reimbursement of sales tax or use tax they have remitted to the Department of Revenue on accounts which are later determined to be worthless. An account is determined to be worthless when it is written off as uncollectible for federal income tax purposes under section 166 of the Internal Revenue Code. ; and " Debit entries are due to customers not remitting tax. Verify that the taxpayer has valid resale/exemption certificates to support them.

### **Fixed Asset Sales**

Examine Summary Records for the sale of fixed assets.

- Review general ledger fixed asset accounts for credit entries.
- Review Schedule D of the taxpayer's federal income tax return.
- Examine gain or loss accounts in the general ledger.
- Trace sales to journal entries, cash receipts and source documents to determine if tax was collected and reported or if the sale was exempt.
- Review depreciation schedule.
- Review fixed asset requisition or appropriation.
- Review accountant analysis of fixed asset accounts and transactions.

- Review construction in progress account.

## **Deductions**

Verification of deductions is an important area of an audit; the deductions are the difference between total sales and taxable sales.

Deduction items include:

- Deductions supported by certificates;
- Deductions based upon sales destination;
- Deductions for sales and services specifically exempt by sales tax law and rules; and
- Deductions for adjustments to sales when sales tax has been paid. Adjusted for overpayment credit.

Normally, the review and reconciliation of deductions is made at the same time as that for total sales. Whenever feasible, adapt the audit procedure to the method used by the taxpayer to report deductions. The scope of the examination of deductions will depend on the conditions encountered. Deductions consist of total nontaxable sales claimed by the taxpayer. Most claimed deductions are supported by resale and exemption certificates and exemptions by law.

Conduct a detail examination if:

- Claimed deductions consist of relatively few items.
- All transactions can be examined in a reasonable amount of time.

Consider a sample examination if:

- Sales are numerous.
- Sales are of similar unit value.

Consider a stratified sample if:

- There is a large variation of price for units sold.
- There is only an occasional large sale.
- There are sales by product code.
- There are sales by department.

## **Certificates**

Deductions can be supported by various certificates that relieve the seller from liability for collecting the tax if the seller accepts the certificates in good faith.

The presentation and acceptance of resale certificates for sales of tangible personal property and taxable services, the requirements for the presentation and acceptance of

exempt use certificates for sales of tangible personal property and the rules for determining when sales of property or taxable services are sales for resale are outlined in Regulation 830 CMR 64H.8.1.

Types of certificates are:

- Resale Certificate ST-4;
- Exempt Use Certificate ST-12;
- Multiple Points of Use Certificate ST-12
- Department of State (88-3 AP621.3.1);
- Exempt Organization Certificate ST-5;
- Contractors Exempt Purchase Certificate ST-5C;
- Small Business Energy Certificate ST-13;
- Exempt container certificate ST-12EC;
- Exempt medical equipment ST-12B;
- Direct Payment Permit ST-14;
- Multi-Jurisdictional Certificates (accepted if the certificate contains the information prescribed by the Commissioner per statute and the corresponding Regulation 830 CMR 64H.8.1.

### **Resale Certificate**

A resale certificate is a document that is presented to the seller at the time of purchase, allowing the purchaser to buy the item tax-free. All blanks on a resale certificate should be completed. Pay particular attention to the description of the property being purchased to be resold. Compare the description on the resale certificate with the description on the sales invoice to determine if the certificate applies. In accordance with Chapter 64H section 8 (b), a certificate shall relieve the vendor from the burden of proof only if **taken in good faith** from a person who is engaged in the business of selling services or tangible personal property of the same kind as the services or property sold and who hold the registration at the time of purchasing the service or tangible personal property.

### **Exemption Certificate**

An exemption certificate is a document similar to the resale certificate. Exemption certificates describe the reasons claimed for exemption from the tax. Verify that the sale was to the entity claiming exemption rather than the individual connected with the Entity. In accordance with Chapter 64H, section(s) 8 (e)-(h) and Chapter 64I, section(s) 8 (g)-(j), the burden of proving that a sale of tangible personal property is exempt remains on the vendor unless the vendor accepts an exempt use certificate from the purchaser **in good faith who**, at the time of purchasing tangible personal property intends to use the property in a manner that qualifies for an exemption per Chapter 64H & Chapter 64I or who is unable to ascertain at the time of purchase whether the tangible personal property will be used in an exempt manner or used for some other purpose.

Certificates not taken in good faith are subject to sales and/or use tax in accordance with Chapter 64H & Chapter 64I of the MGL.

### **Agency Relationships:**

In accordance with DOR Directive 07-6, any person or entity, contractors included, may purchase items covered by Chapter 64H, sections 6 (r) and (s) without payment of tax provided that the property itself will be used in a manner specified by the statute. A showing of agency is no longer required for exemption under section 6(r) and section 6(s) and is limited to these two sections of the statute only.

For parties or entities purchasing items which may be exempt under Chapter 64H, sections 6(d) and (e), establishing an agency relationship will continue to be necessary if the party purchasing the items is not itself an exempt purchaser.

Following the general contractor rule, contractors are the consumers of tangible personal property that they purchase for use in the fulfillment of their contracts as specified in the contractor regulation, Emergency Regulation No. 12. However, construction contractors furnishing only construction management services or other "qualified services" with respect to a particular project may be eligible for the exemption per Chapter 64H, section 6(tt).

An exemption certificate is not required if the purchase is:

- Made by government agencies or a Massachusetts political subdivision.
- Exempt by statute.

### **Exemption Categories**

Exemptions from sales and use tax for specific items of tangible personal property and specific types of customers are provided under Chapter 64H, sections 6(a) through 6(ww). Each category needs to be studied to determine whether a full or partial exemption exists.

The following is a partial list of exemptions:

- Certain ships and vessels (64H, s.6(o));
- Sale of United States Flag (64H, s.6(w));
- Containers, Packaging Supplies and wrapping (64H, s.6(q));
- Food products (64H, s.6(h));
- Gas and Electricity (64H, s.6(i)(qq));
- Gold and silver (64H, s.6(ll));
- Governmental entities (64H, s.6(d));
- Medicine (64H, s.6(l));
- Interstate Commerce;
- Sales of Article of Clothing up to \$175 per article (64H, s.6(k));
- Newspapers and magazines, 64H, s.6(m));

- Property used for improvement of realty of an exempt organization (64H, s.6(f));
- Religious, educational and charitable or scientific (64H, s.6(e));
- Sales of Aircraft (64H, s.6(vv));
- Solar Energy Devices (64H, s.6(dd)); and
- Water (64H, s.6(i)).

### **Consular Tax Exemption Cards**

Effective June 1, 1988. The foreign diplomat should present his or her consular tax exemption card to the vendor when purchasing taxable merchandise.

A consular tax exemption card is issued by the U.S. Department of State, is not transferable, and may not be used by others, including spouses.

Vendors of Sales, Meals and Rooms Taxes:

Diplomats may obtain an exemption from these taxes by presenting a valid tax exemption card issued by the U.S. Department of State. As of January 1, 2002, State will issue only two types of exemption cards. The Blue stripe card exempts all purchases, both personal and official, from the sales tax. The Yellow stripe card exempts all purchases except as restricted on the face of the card. Certain exemptions may apply for the diplomat or for the mission that the diplomat represents such as all sales including hotel rooms; all sales except hotel rooms, all sales over an aggregate amount including hotel rooms and all sales over an aggregate amount with restrictions per the card.

The United States Department of State has also informed DOR that unless a diplomatic exemption card specifically states that the bearer is not exempt from the rooms tax, no rooms tax may be imposed. For audit purposes, the vendor must adhere to procedures detailed in AP 102.3.1 or AP 621.3.1:

### **Sales Tax Holiday Purchaser's Certification of Nonbusiness Use**

- Examine the taxpayer's certificate file. Are all transactions totaling \$1,000.00 or more that qualify for the sales tax holiday exemption listed to certify the items are being purchased for personal use and not for any business use?
- Check certification for:
  - Name of purchaser and address
  - Signature of purchaser
  - Phone number
  - Receipts attached

## Review of Certificates

Examine the taxpayer's certificate file. Is the certificate updated or current? (A taxpayer's number by itself does not make a certificate.)

- Check certificates for:
  - Name of purchaser and address
  - Valid taxpayer number (not required for the Exemption Certificates)
  - Signature of authorized person
  - Date
  - Description of items purchased
  - Description of purchaser's type of business.
- Check for certificates that are qualified.
  - Certificate specifies that only certain purchases are tax free or,
  - That all purchases are tax free with the exception of certain items.
- In deciding if a certificate is sufficient in content and if a seller acted in "Good Faith" in accepting the certificate, these questions should be considered:
  - Was the merchandise sold to a retailer who does not sell that particular type of merchandise? For example, a gas station presents a Resale Certificate (ST-4) to a vendor when it purchases a television.
  - Did the seller have knowledge that the particular item sold was to be consumed by the purchaser? Other factors: Was the purchaser registered at the time of purchase (especially resale)? Does the date on the certificate reflect this fact?
- Compare some sales invoices with certificates to verify sales claimed as deductions. Deductions should be supported by properly completed certificates.
- Do not schedule obvious sales for resale or sales to governmental entities.
- List all unsupported tax free sales on a schedule. Give copies of schedules to the taxpayer for review.
- Allow the taxpayer the time to review the schedules and acquire applicable certificates as required by statute under MGL, Chapter 64H & I, section (8). See discussion of Sixty-Day Rule below.

Note: Certificates are not required for the following:

- The United States government.
- Sales that are exempt by statute.
- Sales, which by their nature, qualify for a resale or other exemption, such as sales of bales of cotton to a clothing manufacturer.

## Sixty-Day Rule

If additional taxable sales are found which resulting from missing certificates, a Notice of Exceptions (60-day Letter) should be issued. This notice allows taxpayers 60 days from the date it is issued to provide any additional certificates.

In accordance with MGL , Chapter 64H, section 8 and by corresponding Regulation 830 CMR 64H.8.1, Resale and Exempt Use Certificates, vendors are permitted **only 60 days** following notice by the Commissioner "to provide an applicable resale and/or exemption certificate."

To enforce the law, it will be vital to have obtained a **signed** Notice of Exceptions evidencing the date the taxpayer was put on notice for all untaxed sales that were made on or after March 6, 1991.

The notice will contain the following information:

1. The date it was issued and read;
2. The specific date of expiration of the sixty days; and
3. Signature of both the taxpayer and auditor.

An entry should be made in the Audit WorkBench (AWB)-Case Log documenting the date of issue and whether or not the taxpayer signed or refused to sign the Notice of Exceptions.

Within the 60-day period, the taxpayer may produce a certificate that is missing or correct a certificate deficient in some manner.

It is important to note that the 60-day period **cannot** include the 30-day period given by the Notice of Intention to Assess. Accordingly, the notice should be sent to the taxpayer as early as possible in the audit process.

## Adjustments to Error Factor

Upon completion of the field examination and copies of the work papers listing the exception items are presented to the taxpayer along with a Notice of Exceptions, the following events can occur before the work papers are finalized:

- The taxpayer may present additional resale certificates (Form ST-4) for consideration and said transaction may be removed if the vendor has proven the certificate was taken in good faith.
- The taxpayer may present additional exempt use certificates (Form ST-12) for consideration and said transactions may be removed if the vendor **accepts the certificates in good faith.**
- The taxpayer may receive an adjustment on the work papers if it can be documented that a use tax was accrued and actually reported to the DOR on a

tax return by their customer. In instances where a customer proves that use tax was paid, the auditor shall issue a Vendor Notification to the taxpayer which informs them that this will not be allowed in the future.

Any of the above occurrences may warrant an adjustment to the work papers and applicable error factor calculation.

## **Referrals**

Some certificates accepted on audit due to a good faith acceptance may warrant referral for a follow-up use tax audit of the purchaser. Such referrals should always detail the underlying reasons for acceptance or non-acceptance and if not voluminous, a list of transactions identified. Referrals should be made using the Intradepartmental Field Audit Referral Form A-40C. (See Chapter 5 - Audit Completion: Documentation of Findings & Administrative Remedies).

## **Sales to Destinations Outside of Massachusetts**

The sale of tangible personal property that, under the sales contract, is shipped to a point outside of Massachusetts is exempt from tax as qualified under Chapter 64H, s.6(b) and as governed by 830 CMR 64H.6.7, Out-of-State Deliveries Regulation. If a vendor is obligated to deliver to an out-of-state purchaser's address or to an interstate common carrier for such delivery, the sale is not taxable in Massachusetts. However, any taxable item brought into the state within six months of purchase for use, storage or consumption in Massachusetts is subject to the use tax under Chapter 64I, section 8(f).

Massachusetts sales and use tax law generally requires a business with nexus in Massachusetts to collect tax when it ships goods to a customer in Massachusetts on behalf of a retailer that is not required to collect the tax because it does not have nexus with Massachusetts. (Refer to Technical Information Release 04-26, Drop shipment provisions).

## **Cash Discounts, Coupons and Rebates**

The deduction for cash discounts, coupons and rebates is covered by Regulation 830 CMR 64H 1.4, Discount Coupon and Rebates. The following are general rules, but special circumstances may warrant additional research.

## **Discounts**

Cash discounts are allowed and taken at the time of sale are excluded from the sales price of tangible personal property upon which the sales tax is based.

Trade discounts allowed and taken at the time of sale on sales made to certain customers of a business are excluded from the sales price of tangible personal property upon which the sales tax is based.

### **Manufacturer's and Retailer's Coupons**

Generally, manufacturer's and retailer's coupons that entitle the retail customer to a reduction in sales price at the time of sale will be treated like cash discounts.

### **Scan Cards**

Manufacturer's and retailer's coupons in paperless form will generally be treated the same as paper coupons.

Coupons, certificates or vouchers issued in connection with "bundled transactions" are not manufacturer's or retailer's coupons any reduction in the amount paid by the retail customer will not be treated as a cash discount.

### **Coupons for Free Merchandise**

If a vendor offers a customers, upon presentation of a coupon, merchandise unconditionally free of charge, merchandise free of charge with the purchase of other merchandise or two items for the usual price of one, the sales price subject to tax is the amount the vendor charges the customer.

### **Returned Merchandise**

Returns of taxable merchandise are deductible if the following conditions are met:

- The original sale has been reported as taxable, and the taxable sale price less handling fee; and
- The entire sales tax is returned within 90 days from date of sale.

Are handling or restocking charge does not affect the deduction allowed for returned merchandise.

### **Even Exchanges**

Repair, replacement or exchange of an item for an identical or similar item with no additional consideration from the retail customer is neither a rescission of the retail sale nor an additional sale as there is no additional consideration, thus no additional sales tax is due, even if the following conditions apply (Refer to Letter Ruling 03-8):

- The retail customer is unable to produce the original sales receipt or other verification of the date and place of the purchase; or

- The exchange or replacement takes place more than (90) days after the original retail sale.

## **Bad Debts**

Bad Debt reimbursement claims must be filed on Form ST-BDR or ST-BDR-Meals for sales on meals based on their fiscal year for federal tax purposes after 1999 for reimbursement of sales tax or use tax they have remitted to the Department of Revenue on accounts which are later determined to be worthless (Refer to Technical Information Release 00-3). Any bad debts deducted by the taxpayer on their regular return should be disallowed and assessed on audit.

## **Detailed Procedures For the Audit of Purchases**

Taxable purchases are taxable items:

- Purchased for personal or business use from out-of-state or in-state vendors on which no Massachusetts sales or use taxes were paid or accrued;
- Removed from a tax-free inventory for personal or business use;
- Purchased tax-free for an exempt use which are later used in a taxable manner;
- For personal or business use purchased from out-of-state vendors on which another state's sales tax was legally due and paid. Additional use tax is due when the items are brought into Massachusetts if the other state's tax is less than the sales tax due in Massachusetts. If tax is paid to an out-of-state vendor that was not legally due, credit is not allowed. In general, tax is not legally due in another state where the tangible personal property was shipped to Massachusetts. Credit for tax paid in another state will not be recognized where the purchaser is entitled to a refund or credit (Refer to Technical Information Release 03-1).
- Originally purchased for resale but subsequently put to business or personal use. Such purchases could be subject to a 'use tax" or a "sales tax" depending upon whether an exemption certificate had been issued by the taxpayer to the vendor of the item(s). The auditor should determine, if possible, whether the item(s) were purchased from a Massachusetts vendor or a registered out-of-state vendor. See Chapter 64H, sections 8(d) and 8(h), and Chapter 64I, sections 8(e) and 8(j). Any assessments made based upon these sections should be cited on the Notice of Intention to Assess (NIA), the Supervisor's or Manager's Exit Conference Letter and on the work papers.
- Use Tax Exception: No use tax would be due in instances where items are purchased from an unregistered out-of-state vendor and temporarily stored in Massachusetts for subsequent shipment and use outside of Massachusetts (See Regulation 830 CMR 4H.6.7(3)(b)3).

## **Internal Control Questions to Be Analyzed and Evaluated for Taxable Purchases**

### **General Controls**

- Are all purchases routed through the purchasing department?
- Are any purchases made electronically via e-commerce or via the use of purchasing cards (P-Cards)? If so, identify the accounts affected and the process of accounting.
- What is the policy for issuing resale or exemption certificates? Is a certificate or declaration part of the purchase order?
- Are purchases made by cash? If so, what records are available to support these purchases? What kinds of purchases are made by cash?
- What is the taxpayer's definition of an asset? Does the Depreciation Schedule account for all capital assets? How are asset write-offs or retirements accounted for? What dollar amount is capitalized? Does the taxpayer manufacture equipment for use in the business? Are parts taken out of inventory to manufacture this equipment?
- How are inter/intra company transfers handled and booked?

### **Document Controls (Invoices and Purchase Orders)**

- What is the volume of purchases per month? Are there any seasonal purchases fluctuations?
- What is the control over purchase invoices? What department makes purchases? Who is authorized to make purchases?
- Are purchase invoices matched with purchase orders or receiving documents? Are purchase invoices numbered so that invoices can be processed by check or voucher number? Were there any changes to the numbering or filing system?
- How are purchase invoices filed (i.e., alphabetically, by invoice number, check number, voucher number, year, month or other)?
- Does the actual purchase invoice or order have the account code written or stamped on it?

### **Recording Process Controls**

- Does the taxpayer maintain an accrual account for use tax? Is location of the vendor and/or point of first use or storage incorporated in the coding?
- Are the purchases recorded in a summary journal?
- Is a cash disbursement journal, check register, voucher or warrant register available for the entire audit period?
- Is there an accounting manual and employee approval for determining distribution of invoice charges to general ledger accounts?
- Is the distribution of charges double-checked periodically?
- Is the accounts payable ledger balanced periodically with the general ledger control account?

- What controls are used to insure that all purchases and tax accruals were processed to the computer and recorded?
- How are credits for goods returned to vendors accounted for? How are damaged goods, back orders, trade-ins and inventory withdrawals accounted for?
- Are purchases made for employees cleared through the regular purchasing procedures? How are employee reimbursements accounted for?
- Are detailed records computerized? If so, would it be feasible to use computer audit techniques?
- What are the procedures and policies for computer coding for:
  - Account distribution?
  - State and local taxes?
  - Tax rates?
  - Taxable or exempt sales?
- Is the coding maintained and kept up-to-date? How are law changes and the items impacted by the change incorporated into the coding system?
- How are prior contract exemptions handled?

### **Audit Procedures For Taxable Purchases**

In examining taxable purchases, perform the following steps:

- Determine the taxpayer's knowledge of the law pertaining to taxable purchases including energy and telecommunication services;
- Evaluate the system of internal controls to determine reliability of the records;
- Determine how the taxpayer accounts for taxable purchases;
- Analyze the tax accrual account and compare to the reported tax. Evaluate all differences; and
- Review all pertinent books and records relating to taxable purchases (See Records to Examine).

The audit procedures used will depend on each specific taxpayer situation. The auditor will have to make some of the following decisions using auditor judgment:

- What expense accounts should be analyzed? The expense accounts should be evaluated based upon materiality and other audit circumstances (i.e., tax law change items, manufacturing exemptions, account code changes, etc.).
- What is the expense for services paid in connection with the purchase of taxable tangible personal property?
- Should expense accounts be sampled or detailed? Consider the volume and detail of the records, the completeness of the records and the cost/benefit and the relationship of the procedures involved.
- If sampling procedures are implemented, what sampling unit will be used (i.e., transactions, clusters, months, etc.)?
- Determine what the source of the data for the test will be. Will it be the general ledger detail for the accounts selected or will it be from accounts payable for the

accounts selected. If taken from accounts payable, the general ledger needs to be verified for the selected accounts to make certain that there are no purchases charged to the accounts that are not running through accounts payable.

- The sampling unit will depend on a couple of factors:
  - The taxpayer's record keeping method (i.e., how invoices are filed).
  - If records are missing, etc.

Once these decisions are made, audit procedures can be implemented.

- Examine source documents in detail or by sampling.
- Schedule all additional taxable purchases on which tax was not reported.

### **Records to Examine**

- Review the following records for unreported taxable purchases and services.
- General Ledger;
- Depreciation Schedule;
- Federal Income Tax returns for expenses and asset purchases or services;
- Tax accrual work papers; and
- Chart of Accounts. Look for:
  - Expenses involving tangible personal property, energy and telecommunications services;
  - Advertising (for promotional items, etc.);
  - Miscellaneous expenses;
  - Construction in progress - Auditors must be consistent when reviewing this account to make sure the date of taxation is reflective of their records (i.e., selecting the purchase date, invoice date, capitalization date or placed in service date;
  - Capital assets;
  - Demo Equipment;
  - Overhead expenses (office supplies, paper, etc.);
  - Repair and maintenance supplies;
  - Computer supplies and expenses;
  - Samples;
  - Operating supplies; and
  - Office and selling expenses.
- Purchase invoices. Look for:
  - Description of items purchased;
  - Invoices that include taxable purchases along with inventory items (i.e., display items, samples, etc.);
  - Unpaid invoices (accounts payable);
  - Charges for taxes; and
  - Account codes.
  - Note: Occasionally, an invoice may describe merchandise in technical jargon or be a catalog number. An examination of the related purchase

order or other documents may be necessary to explain the purchase invoice. The account code, department purchasing the items, the receiving document and the purchase order would help in identifying the product.

- Contracts, job files;
- Purchase Orders;
- Cash disbursement and purchase journals;
- Accounts payable and notes payable ledgers;
- Accounts payable distribution or voucher registers;
- Journal entries for inventory transfers;
- Journal entries for asset or expense transfers between related companies;
- Journal entries for asset or expense transfers from suspense accounts or centralized distribution points;
- Leases of assets or construction of assets by the taxpayer;
- Asset ledger/file; and
- Financing leases.

Tour the facilities to understand and examine assets maintained and possible manufacturing exemptions. Manufacturers are allowed certain purchase exemptions depending on how the purchases are used in processing and also their useful lives. Make inquiries of the purchase manager.

### **Verifying the 75% Requirements for the Exemptions of Certain Power Used on Manufacturing**

The exemption for electricity under MGL Chapter 64H, section 6 (i) states in part:

"The sales, furnishing or service of....(3)....gas, steam or electricity consumed and used directly and exclusively in an industrial plant in the actual manufacture of tangible personal property to be sold or in the heating of such industrial plant; provided that the exemption under this paragraph (3) shall only be allowed with respect to a metered building, location or premises at which not less than seventy-five percent of the gas, steam or electricity consumed at such metered building, location or premises is used for the purposes of such manufacturing or heating...."

In accordance with Technical Information Release 98-5, a safe harbor may be used as an alternative means to establish that it satisfies the seventy-five percent exempt use requirement for either gas, steam or electricity at a billed meter, or, if the taxpayer has internal meters that subdivide the power recorded at a billed meter, by reference to gas, steam or electricity recorded at each internal meter.

Under the terms of the 6(i) safe harbor, gas, steam or electricity used by the taxpayer to light or air condition a portion of the building, location or premises which the taxpayer performs actual manufacture will be deemed to be used "for purposes of the actual manufacture" and thus counted towards satisfaction of the seventy-five percent test. Actual manufacture for the purpose of this safe harbor will be deemed to include short-term storage or transportation of in-process manufacturing goods (not including

raw materials or finished goods) when that storage or transportation takes place contiguous to the actual manufacturing activity. Any electricity used for purposes of research and development may be eliminated from the percentage calculation.

The taxpayer may claim the 6(i) exemption for all power recorded on each meter at which the seventy-five percent test is met. If a taxpayer is unable to demonstrate eligibility for the 6(i) exemption by measuring manufacturing activities attributable to a billed meter, and it has not subdivided the billed meter into one or more separate internal meters, it may claim the 6(i) exemption if it establishes that the billed meter is dedicated to an industrial plant in which seventy-five percent of the total cubic feet in such plant is used in the actual manufacture of tangible personal property to be sold.

The Commissioner may approve another reasonable method for computing the use of gas, steam or electricity at a billed meter to satisfy the seventy-five percent test provided that such method must be approved in writing by the Commissioner in the form of a Letter Ruling.

In order to determine the 75% requirement noted above the following guidelines should be considered:

1. During the initial stages of the audit a plant tour should be conducted. During this tour the number of meters should be noted. The auditor should ask if the taxpayer keeps internal meters that subdivide the power at the billed meter and obtain said records. If possible, the auditor should utilize the tour to make an initial determination of meters that monitor only exempt activities or taxable activities. The auditor should document this activity in the audit log.
2. If the meters monitor both exempt and taxable activities, the auditor's preliminary evaluation should take a common sense approach to determine if the exempt activity is 75% or greater. A worksheet should be developed showing how the auditor made such determination. For example, if the auditor utilized the cubic feet of the facility breaking down manufacturing areas and non-manufacturing areas, there should be a worksheet showing the computation and how the exempt or taxable determination was made.

## **Tax Accrual Reconciliation**

Some taxpayers have a use tax accrual account that summarizes use tax accrued on taxable purchases. Analyze the use tax accrual account and compare it to reported use tax history. Evaluate all differences. Schedule any unreported use tax. Evaluate all debit entries. This account could be a combination of sales and use tax liability account.

## **Purchase Categories**

Purchases can be divided into the following areas:

- Expense Items-Detail or sampling procedures may be used for expenses. Generally, transactions in this area are numerous and sampling may be

necessary. Schedule as audit adjustments any expense items on which taxes have not been paid to the vendor or reported to the DOR.

- Capital Assets-Generally, the volume of taxable purchases related to fixed assets is smaller than purchases associated with expense items and involves larger dollar amounts. This portion of the audit should be examined in detail. However, if there is a large volume of capital assets, sampling procedures could be utilized. If capital assets are sampled, the purchases must be shown to be consistent in occurrence and dollar value. In most cases, stratification is necessary.
- Construction-In-Progress (CIP)-All vendors in the CIP account must be verified as being resident or non-resident contractors. If non-resident contractors exist, the auditor should ascertain if a bond has been filed consistent with MGL, Chapter 64H, section 30A or 64I section 31A. If the non-resident contractor has not filed a bond, the taxpayer becomes liable for the tax on the cost of materials consumed on the job (Refer to DOR Directive 05-3).
- Items Withdrawn from Inventory-If a taxpayer maintains a tax-free inventory (items purchased with valid resale/exemption certificates) and withdraws items from this inventory for personal use, then taxes are due on the items withdrawn. Tax is based on the cost or fair market rental value.
- Examine the following:
  - Credits to inventory and purchase accounts (These items may be noted on zero dollar sales invoices);
  - Costs of goods section on federal income tax returns;
  - Intra-company transfers; and
  - Journal entries.

Discuss any inventory withdrawals with the taxpayer.

### **Tax Charged on the Invoice**

If a purchase invoice includes a charge for taxes, confirm that:

- Tax was paid on the entire taxable portion of the invoice;
- Taxes charged on the invoice were actually paid; and
- Taxes charged were for Mass. sales taxes or for another state.

If, for another state, check for the following:

- If correctly and legally paid to another state, verification of payment should be made.
- If taxes were erroneously paid to another state, then set up an adjustment for all Massachusetts taxes due. The taxpayer will have to go to the vendor for credit. If tax was erroneously credited to another state, then the taxpayer will have to go to that state for credit.

## **Taxes Not Paid to Vendor**

If taxes were not paid to the vendor as indicated on the invoice, confirm if the taxes were accrued and paid to the state.

- Check to see if any discounts were taken by the taxpayer.
- Double-check that the purchases and services are taxable items.

If tax is not accrued and reported, then make an adjustment for the applicable tax due.

## **Audit Referral Criteria**

If the vendor did not charge any tax and it appears that the vendor has representation in Massachusetts (i.e., vendor is located in Massachusetts, vendor has a salesperson who takes orders in Massachusetts, etc.) initiate a referral (Form A-40C) on the vendor unless it is known that the taxpayer gave the vendor a resale/exemption certificate.

## **Credits/Adjustments Allowed on Audit**

It is the responsibility of the auditor to ensure that the correct amount of tax due the Commonwealth has been reported. Accordingly, the auditor must take into consideration overpayments made by the taxpayer during the audit periods.

Prior to allowing credits on audit, the auditor must test specific accounts to verify the validity of the credit. The auditor must determine whether the overpayment is an unusual transaction or a common and systemic error in deciding if the credit would be Allowed for a specific period or projected through a test agreement to all the audit periods. Taxpayers should be instructed during the opening conference to identify the overpayments and provide the required documentation to substantiate the allowance of credits by the auditor. This documentation should be provided by the taxpayer within sixty days from the date of the opening conference. Extensions to the sixty day time frame must be approved by the supervisor.

The following guidelines should be followed by the auditor when verifying credits and overpayments:

- If the taxpayer imposed a sales tax on an exempt transaction, the auditor must ensure that the taxpayer has issued a credit or check to its customer before a credit can be allowed on audit. The auditor should also verify that the taxpayer has not previously received an abatement of tax on the transaction by checking MASSTAX. In addition, a taxpayer "NOTE" should be entered into the MASSTAX system to warn the Abatement Bureau about the allowance of the credit by the auditor.

- The auditor must verify that the credit was granted to the customer by examining canceled checks, credit memos, account statements or any other documentation which validates the transaction.
- If the taxpayer filed and paid use tax on exempt transactions, the auditor must allow a credit on audit, assuming that the taxpayer has not already filed an abatement claim. A taxpayer note should be entered into the MASSTAX system to signal a warning to the Abatement Bureau.
- The auditor must verify that the credit was not taken by the taxpayer on returns filed subsequent to the tax period on which the overpayment occurred.
- If the taxpayer paid sales tax directly to the vendor on exempt purchases or items resold, and the vendor remitted the tax on a ST-9 to the department, the auditor should instruct the taxpayer to request a credit from the vendor. The vendor should file an application for abatement for the overpayment of the sales tax. These types of credits are not allowable under audit of the purchaser even if the statute has been extended by the taxpayer.
- If a vendor claims that a sales tax deficiency assessment should not be made on taxable transactions, for which sales taxes were not imposed and there is no resale or exemption certificate, based on the fact that the purchasers have either paid a use tax directly or have been audited for sales/use taxes by the Commonwealth for the periods in issue, the auditor must perform the following tasks prior to allowing an adjustment:
  - Verify documentation and other evidence supporting taxpayer claim of tax paid by purchaser.
  - Provide taxpayer with completed Vendor Notification Form notifying that no adjustment will be made for future taxable transactions made on or after the date of vendor notification.
  - Management will maintain a file on vendor notification forms issued for use in future audits of such vendors.

**All credits/adjustments granted on audit must be approved by the auditor's supervisor or manager.**

### **Service Providers - Use Tax Audit Procedure**

The Audit Division has established the following procedures and guidelines for the auditing of service providers which may have made taxable purchases on which sales taxes were not paid to the vendor and use taxes are owing to the Commonwealth. If it is determined that a pattern misreporting and/or underreporting of use tax exists within a particular business industry, a more in depth review of the industry will take place based on information generated through an RFQ (request for quotation).

### **Registration**

- Service providers which are determined to have made purchases of tangible personal property on which sales taxes have not been paid and use taxes are owed will be required to register with the Department. Registration can be

completed through the DOR's web-based application, WebFile for Business (WFB), and can be found on line at <http://www.mass.gov/dor>.

## **Return Requirements**

- If the auditor determines a taxpayer will be required to file Business Use Tax returns (ST-10), the auditor will provide the audit work papers.
- The taxpayer will prepare a single annual return (Business Use tax return, Form ST-10) covering a twelve month period within the calendar year in which a use tax is due.

## **Penalty Waivers**

- Requests for the waiving of late file and late pay penalties will be considered in accordance with the Department's guidelines promulgated under Administrative Procedures 633 (AP 633). The taxpayer should make their request in writing to demonstrate that reasonable cause and not willful neglect existed in accordance with AP 633. The taxpayer's request should be submitted with the returns for consideration.

## **Audit Process Flow Chart**

Conduct Opening Conference

Tour Facilities

Analyze Reporting Categories on Sales/Use Tax Return

Review Taxpayer Reporting Methods

Review Internal Controls to Determine Reliability of Accounting System

Reconcile Recorded and Reported Sales (reconcile gross sales and taxable sales; sales tax and use tax using Taxpayer's return back-up)

Conduct a Preliminary Review of Taxpayer Records to Determine if records Reflect their Method of Accounting

Determine Whether Sampling Procedures/ Detailed Audit will be Employed

Determine Sampling Methods and Application of Sampling Procedures

Apply Audit Procedures and Complete the Following:

Examine Sales Records-Send 60-Day Letter to Taxpayer with Preliminary Sales Audit Work Papers

Examine Purchase (Expense) Records

Examine Fixed Asset Records

Complete Listing of Exceptions on the Audit Work Papers

Present Preliminary Audit Work Papers to the Taxpayer for Review

Scan and Attach Supporting Documentation in Audit WorkBench (AWB)

Schedule an Exit Conference to Review Audit Work Papers

## Chapter 8

# Meals and Room Occupancy Tax Auditing Procedures

### Introduction

As with any other tax audit, the primary purpose of meals and room occupancy tax audits is to verify that the taxpayer has reported the correct amount of tax. In most tax audits, including meals and room occupancy tax audits, this is accomplished primarily through the review of the taxpayer's records. In many instances however, the auditor will need to utilize other means of verifications. Generally, this will include observation of the taxpayers operation and third party confirmation.

### Administrative Details

#### Identifying Responsible Person(s)

In order to facilitate the collection of tax liabilities imposed on corporations and partnerships by MGL chapters 62B, 64G, 64H and 64I, auditors must identify the responsible person(s) who are liable for such trustee taxes pursuant to M.G.L. Chapter 62C, section 31A and Regulation 830 CMR 62C.31A.1.

The identification of responsible persons must be done for all trustee tax audits. Auditors must document in the audit narrative and Audit WorkBench (AWB)-Case Log the names of the individual(s) responsible for paying over the trustee taxes. This information must also be entered into the MASSTAX system under the taxpayer "NOTE" screen.

#### Bank Account Information

During the course of the examination, the auditor must gather the following information relating to the taxpayer's banking activity:

- Name of bank(s) in which the taxpayer has account(s); and
- Account(s) numbers.

If the taxpayer has more than three (3) accounts, the auditor must get the above information for the taxpayer's three primary accounts. The information must be noted in the audit narrative and documented in the MASSTAX system under the taxpayer "NOTE" screen.

#### Bankruptcy Information

When a taxpayer files the bankruptcy case, the automatic stay prohibits all of the taxpayer's creditors,

including the Department of Revenue, from taking any action to collect any debts or liabilities that relate to the time period before the Petition Date. During the course of the initial taxpayer contact, the auditor should ask the taxpayer if they are in bankruptcy. If the taxpayer is in bankruptcy, the auditor must obtain the following information and forward it to the Litigation Bureau's Bankruptcy Unit immediately:

- The location of the Bankruptcy Court;
- The Bankruptcy Court docket number (stamped on the bankruptcy petition); and
- The petition date (the date the bankruptcy case was filed).

The information must be noted in the audit narrative and Audit WorkBench (AWB)-Case Log to ensure the necessary steps are taken to contact the Bankruptcy Unit in a timely fashion.

**Note: Bankruptcy procedures are discussed in detail within Chapter 6-Specialized Audit Procedures of the Field Audit Procedures Manual.**

## **Records Retention**

Document all requests for records in the Audit WorkBench (AWB)-Case Log. If there are any problems in obtaining necessary records, a written request for those records should be sent to the taxpayer. **If the taxpayer claims not to have certain records that are required by the 830 CMR 62C.25.1: Records Retention Regulation needed for review, A Statement of Records Retention, should be executed and signed by the taxpayer and/or taxpayer's representative.**

## **Case Plan**

The Audit WorkBench (AWB)-Case Plan will be used to guide the progression of each case. The case plan is structured to allow for flexibility of workflow and is broken into primary tasks and subtasks. When all of the subtasks are completed within a certain primary task, it will automatically be recorded in Audit WorkBench-Case Log

## **Meals Tax**

### **Overview**

In accordance with M.G.L Chapter 64H, Massachusetts imposes a 6.25% sales tax on meals sold by or purchased from restaurants or any part of a store considered by Massachusetts law to be a restaurant. The tax is based on the sales price of the meal. In general, a food product commonly thought of as a grocery item is exempt from the sales tax on meals (See Regulation 830 CMR 64H.6.5: Sales Tax on Meals).

A meals tax "vendor" is anyone who sells meals that are subject to sales tax in Massachusetts. Vendors must add a 6.25% sale tax to the selling price of every taxable transaction and collect it from the purchaser.

A "meal" is any food and/or beverage that has been prepared for immediate human consumption and provided by a restaurant or restaurant part of a store. A meal includes food or beverages sold on a take-out or to go basis, whether or not they are packaged or wrapped, and whether or not they are taken from the premises of the restaurant.

A "restaurant" is any eating or drinking establishment, whether stationary or mobile, temporary or permanent, where food, beverages, or food products are provided and for which there is a charge. The list includes, but is not limited to following:

- Cafes;
- Cafeterias;
- Canteen trucks or wagons;
- Catering businesses;
- Cocktail lounges and bars;
- Diners;
- Dining Rooms;
- Hotel, motel dining rooms;
- Ice cream trucks and food stands;
- Lunch counters;
- Private and social clubs;
- Salad bars;
- Street wagons or carts;
- Taverns; and
- Vending machines that sell snacks or candy with a sales price of \$3.50 or more.

A "store" is any establishment that is not primarily engaged in the business of selling meals. In general, food products for human consumption sold by stores are exempt from the sales tax. However, any store that contains an area, section or counter where food product is prepared and meals are sold must charge a sales tax on those meals. Such a store is considered to have a restaurant part. Stores that may have a restaurant part include the following:

- Supermarkets;
- Grocery stores;
- Bakeries;
- Delicatessens;
- Convenience stores; and
- Markets.

## **Registration and Filing Obligation**

Return filings and tax payment methods depend on each entity's combined trustee tax liability for the preceding year. Businesses that registered on or after September 1, 2003, must file returns and pay taxes electronically, regardless of the amount of their annual tax liability.

Previously registered businesses with combined annual withholding, sales/use tax (including sales tax on meals and telecommunication services) and room occupancy excise liabilities of \$10,000 or more are required to file returns and make payments electronically. Previously registered businesses with a combined annual liability of less than \$10,000 may file paper returns, but are encouraged to file electronically.

## **Taxable Sales Price**

The sales tax is imposed on a meal based on the price of that meal. However, in certain instances, the sales price of a meal may include the tip, room rental or recreational admission charge as the basis which is subject to the tax. The following list includes situations where these items are considered taxable:

- Gratuities, service charges or tips added by the restaurant to the price of a meal are included in the taxable sales price if they are part of the consideration paid for the meal. However, separately stated gratuities, service charges or tips are not considered taxable if they are distributed in their entirety to those employees provided the service; and are accounted for separately in the taxpayer's records (See Regulation 830 CMR 65H.6.5(7)(a); and **Chatham Bars Inn, Inc. v. Commissioner of Revenue, No. F225093, April 29, 1998**);
- A room rental for the purpose of serving a meal, where the meal is provided by the operator of the room, is included in the price of the meal subject to meals tax, whether separately stated or not;
- Admission charges collected by a place of entertainment where food and/or alcoholic beverages are sold are taxable unless all of the following conditions are met: a ticket is sold and collected; the patron is not required to purchase any food or beverage, the charge is for admission only and does not include any payment for food or beverage and the admission charges are segregated from other receipts in the books and records of the place of entertainment.

## **Exempt Organizations - Sales of Meals**

Under M.G.L Chapter 64H, section 6(d) sales made to government organizations including the United States and its agencies, the Commonwealth of Massachusetts, and any of its political subdivisions and their respective agencies are exempt and prohibited from taxing under the Constitution or laws of the United States.

1. The sales of meals made to nonprofit organizations are exempt from taxation under Section 501(c)(3) of the Internal Revenue Code provided the following criteria are met:
  - The meals sold to the 501(c)(3) organization are used to further its exempt cause;
  - The exempt organization obtained Form ST-2 (Certificate of Exemption) from the Commissioner stating it is entitled to the exemption;
  - The exempt organization provides a properly completed Form ST-5 (Exempt Purchaser Certificate) and Form ST-2 attesting that the meals purchases are for an exempt use; and

- Sales of meals to persons, groups or organizations including caterers are exempt from meals tax when the purchases are made through or on behalf of an exempt entity in accordance with Regulation 830 CMR 64H.6.5(12)(b) or (d).
- 2. The sales of meals made by an exempt organization for fundraising purposes are considered exempt from the sales tax meals as casual and isolated sales provided that the sales of meals by the nonprofit organization are not made in the regular course of business. However, the Commissioner will consider the factors presented to determine whether the nonprofit organization: sells meals from a retail establishment that it operates; is required to hold a vendor's registration certificate in accordance with M.G.L. Chapter 64H, section 7; or the proceeds from the sales of meals constitute unrelated business income.

### **Certain Other Institutions and Organizations - Exempt Sales of Meals**

The following sales of meals by these institutions or organizations are considered exempt from the sales tax on meals in accordance with Regulation 830 CMR 64H.6.5 in the following instances:

- Health and day care facilities where all meals are both prepared and served by employees of the institution;
- Hot lunch programs for elderly persons through the school lunch program;
- Churches, Synagogues and other Religious Organizations where the meals are prepared and served by members of the organization, the meals are served only to members of the organization, the meals are served on the premises of the organization and any receipts in excess of necessary expenses are donated to the organization;
- Educational Institutions where the sale of meals are exempt to the student body only, and not the faculty or staff, provided the gross receipts are separated in the books and records of the educational institution;
- Summer Camps where the sales of meals are served by summer camps for children who are eighteen years old and younger or for developmentally disabled individuals; and
- Commercial Airlines where the furnishing of meals to commercial airline passengers whether the aircraft is in flight or on the ground is exempt from the sales tax.

### **Sales of Meals Sold Without Alcoholic Beverages**

The liquor license holder is presumed to be the vendor of all meals sold without alcoholic beverages at the licensed premises and is responsible for the collection and payment of the tax imposed by M.G.L. Chapter 64H.

A common victualler is a person licensed to sell meals without alcoholic beverages under M.G.L. Chapter 140. An innkeeper or common victualler is a vendor of all meals sold without alcoholic beverage at the licensed premises and is responsible for the collection and payment of the tax imposed by M.G.L. Chapter 64H.

## **Claiming the Bad Debt Reimbursement**

Massachusetts sales tax vendors who have remitted sales tax to DOR on accounts that are later determined to be worthless may file a claim for reimbursement with DOR. An account is determined to be worthless when it is written off as uncollectible for federal income tax purposes.

Reimbursements are paid annually without interest and may only be claimed on ST-BDR-Meals, Claim for Bad Debt Reimbursement. A claim for a vendor's prior fiscal year must be filed on or before the due date, including extensions, of the vendor's federal income tax return (or annual federal filing in the case of an exempt organization) for the prior fiscal year.

## **Vendors Are Not Allowed to Subtract Bad Debts from Gross Receipts**

Vendors must include in gross receipts for their Sales Tax on Meals Returns all sales for the period in which the sales occur, regardless of whether payment has been received.

Any vendor who recovers, in whole or in part, a bad debt for which a reimbursement has been received must include the recovered amount in the gross receipts amount of the appropriate sales tax return covering the period in which the recovery occurs.

## **Documentation to Submit with Completed Form ST-BDR:**

- If the federal income tax return is on extension, attach a copy of the appropriate federal application for extension form;
- Document each worthless sale and provide an explanation listing the date the sale occurred, the amount of the sale, the buyer's federal identification number, (if available), and all facts pertinent to the determination that the account is worthless; and
- Vendors who are unable to separately document the portion of each worthless account which represents taxable Massachusetts sales may calculate the reimbursement on an aggregated basis (Technical Information Release 92-2).

Note: If filing for Sales/Use Tax, as well as Sales Tax on Meals, complete two separate Forms (use the current period form only.)

## **Local Option Sales Tax on Meals**

### **Overview**

Chapter 64L, Local Option Meals Excise, was added to the General Laws pursuant to St. 2009, Chapter 27, section 60, which establishes the 0.75% local option sales tax on meals. The local option excise takes effect on the first day of a calendar quarter following thirty days after acceptance by the city or town or the first day of the calendar

quarter designated by a city or town. The local option meals tax can be effective October 1, 2009 or later (See Technical Information Release 09-13).

However, a combined state and local tax of 7.00% is added to the total price of the meal, which constitutes the state tax of 6.25% and the local tax of 0.75% for those cities and towns, which adopt the local option sales tax on meals. Reimbursement for the local meals tax must be paid by the purchaser to the vendor. The meals tax vendor must file returns and pay the local option meals excise at the same time and in the same manner as the sales tax on meals is due in accordance Chapter 64L, section 2(a).

## **Room Occupancy Tax**

### **Overview**

In accordance with M.G.L. Chapter 64G, Massachusetts imposes a room occupancy excise tax of 5.7% on the transfer of occupancy, for \$15 or more per day, of any room in a bed and breakfast establishment, hotel, lodging house, or motel for a period of 90 days or less. In addition, each Massachusetts' city and town is permitted to levy a local room occupancy excise of up to 4.5% and 6.5% in the City of Boston, pursuant to the recently enacted legislation in St. 2009, Chapter 27, sections 51 and 52 effective on or after October 1, 2009, where each city or town votes to accept the new rate in accordance with Chapter 64G, section 3A (See Technical Information Release 09-13).

Generally, you are responsible for collecting and remitting this tax if you are an individual or business operating a hotel, motel or lodging house, or private club offering sleeping accommodations and the relationship between you and the occupant is not that of landlord and tenant.

### **Registration and Filing Obligation**

Return filings and tax payment methods depend on each entity's combined trustee tax liability for the preceding year. Businesses that registered on or after September 1, 2003, must file returns and pay taxes electronically, regardless of the amount of their annual tax liability.

Previously registered businesses with combined annual withholding, sales/use tax (including sales tax on meals and telecommunication services) and room occupancy excise liabilities of \$10,000 or more are required to file returns and make payments electronically. Previously registered businesses with a combined annual liability of less than \$10,000 may file paper returns, but are encouraged to file electronically.

## **Exempt Establishments**

Under M.G.L. Chapter 64G, section 2, the following room rentals are exempt from the room occupancy excise tax:

- Lodging accommodations at federal, state or municipal institutions;
- Lodging accommodations at religious, charitable, educational or philanthropic institutions;
- Privately owned and operated convalescent homes or homes for the aged, infirm, indigent or chronically ill;
- Religious or charitable homes for the aged, infirm, indigent or chronically ill;
- Summer camps for children eighteen years of age or under or developmentally disabled individuals; provided; however, that such summer camp which offers its facilities off-season to individuals sixty years of age or over for a period not to exceed thirty days in any calendar year shall not lose its exemption hereunder; and
- A bed and breakfast home. A "bed and breakfast home" is a private owner-occupied house where three or fewer rooms are rented, a breakfast is included in the rent and all accommodations are reserved in advance.

## **Federal Government Employees**

If a federal employee or other federal government officer, including a United States Military employee, is acting within the scope of his or her official duties for the federal government and in that capacity stays in a hotel, motel or other place of public accommodation, that occupancy is exempt from room occupancy excise. The exemption is available whether the federal government pays directly for the room, or the employee pays for the room and is later reimbursed.

## **Government Entities and Non-Profit Organizations**

The occupancy of rooms by employees of any state, its agencies or political subdivisions, and the occupancy of rooms by employees of charitable organizations are subject to tax, whether or not such employees are on official business and whether such employees or their employers made payment for the occupancy.

## **Worthless Accounts**

Massachusetts operators of bed and breakfast establishments, hotels, lodging houses, or motels who have remitted room occupancy excise tax to the Department of Revenue (DOR) on accounts that are later determined to be worthless may request an abatement of the room occupancy excise paid on such worthless accounts. Accounts determined to be worthless are written off for federal income tax purposes as an uncollectible account under section 166 of the Internal Revenue Code. The abatements are issued without interest and must be filed on Form CA-6, Application for Abatement/Amended

Return, on or before April 15th of each year for worthless accounts in the prior calendar year.

Businesses required to file electronically must file Application for Abatement/Amended Returns electronically.

Note: The operator must document each worthless rental and provide an explanation listing the date the rental occurred, the amount of the rental, the occupant's federal identification number (if available), and all facts pertinent to the determination that the account is worthless.

## **Convention Center Financing**

### **Overview**

The Convention Center Act provides for construction and financing of convention centers in the Commonwealth. See St. 1997, Chapter 152. Under the Convention Center Act, a 2.75% Convention Center Financing (CCF) fee is imposed on the transfer of room occupancy by any operator of a hotel, motel or other lodging establishment in Boston, Cambridge, Springfield or Worcester.

The CCF fee is in addition to the state room occupancy tax rate of 5.7% and the local option room occupancy tax rate of 4% in effect for those cities. The Convention Center Act authorizes the Department of Revenue (DOR) to administer the 2.75% CCF fee as a tax under the provisions of M.G.L. Chapter 64G, the room occupancy excise. Effective October 1, 2001, the 2.75% CCF fee was extended to the transfer of room occupancy by an operator of a hotel, motel or other lodging establishment in West Springfield or Chicopee. The 2.75% CCF fee is collected and remitted in the same and at the same time as the room occupancy rate on Form RO-2F (See Technical Information Release 01-15).

The legislation imposes a Convention Center Financing fee and three CCF surcharges, all effective January 1, 1998. The legislature granted authority to the Commissioner to administer the CCF surcharges as though they were taxes and make them subject to all the tax administration provisions of Chapter 62C (See Technical Information Release 05-1).

The surcharges include the following:

1. A 5% CCF surcharge on the purchase price of a ticket for any water-based sightseeing, tourist venue or entertainment cruise or tour, and for any land-based sightseeing, tourist venue or trolley tour conducted partly or entirely within Boston. The surcharge is collected and paid by the operator of any tour or cruise and reported to the DOR on Form CCF-ST;

2. A \$10 CCF surcharge on any vehicle rental contract in Boston. The surcharge is collected and paid by the vendor operating a vehicle rental establishment and reported to the DOR on Form CCF-VR; and
3. A \$2 (per day) CCF surcharge on any vehicle that parks in any parking facility built in Boston, Springfield or Worcester in conjunction with the projects authorized by this legislation. The surcharge is collected and paid by the operator of a parking facility built in conjunction with a convention center facility and reported to the DOR on Form CCF-PF.

**Although there are three Convention Center Financing surcharges, a meals tax auditor is generally responsible for auditing the surcharge on sightseeing tours.**

### **Preliminary Analysis**

The auditor should research, as much as possible, every aspect of the taxpayers operation before making contact with the taxpayer. The auditor should first review the MASSTAX historical tax information on the taxpayer. Corporate or personal income tax returns must be reviewed in order to document and reconcile the amount of gross receipts reported for income tax purposes with the amount of gross receipts reported for meals tax purposes. An observation of the taxpayers operation should be undertaken with findings being recorded onto the Observation Report Form. NYNEX Yellow Pages and newspapers advertisements may also provide valuable information and should be included in the audit package if relevant to the audit findings. The inspection of city/town records should be considered in verifying the taxpayer's licensing authority and facility capacity if warranted.

An auditor's observation of a taxpayer's business is useful in developing an understanding of the operation and its accounting in the books and records subject to examination. The hours of operation, the size of the establishment, the number of cash registers used, and whether the taxpayer is operating with an open drawer or ringing in "no-sales" are factors to be considered in testing the accuracy of the taxpayer's records and serve to support the auditor's determinations and findings on appeal. Discoveries made through observations of the taxpayer's business operations and practices must be fully documented in the Audit WorkBench (AWB)-Case Log.

### **Opening Conference**

A field audit begins with an opening conference. In addition, the auditor is expected to secure additional detail about the taxpayer that will be used to conduct the audit more efficiently and identify issues for review. Prior to the opening conference, the auditor will prepare a list of questions to be addressed which will provide for an understanding of the operation and records which will uncover any problem areas prompting the auditor to raise additional questions when appropriate during the interview. The auditor should have the taxpayer sign a Statement of Record Retention in cases where the taxpayer has stated that he has not maintained the requested records. The taxpayer or taxpayer's representative should be asked to explain or provide the following:

- The reporting method utilized.
- The step-by-step process by which the information is obtained and summarized to prepare the return. (This information includes the records used to prepare the return.)
- Any work papers used to prepare the return. (These should be checked for completeness and whether they include all areas subject to tax.)
- General Ledger accounts that have been used by the taxpayer in reporting. (Check for related accounts when the Chart of Accounts is reviewed.)
- Changes in personnel who prepared the return. Obtain the name and position of anyone who prepares a specific portion of the return.
- Menus, brochures and other relevant information covering the audit period.
- Resale/exemption certificates for tax-free sales.
- Items included in deductions and taxable purchase.
- Unusual areas (i.e., changes in reporting method, etc.).
- If the reporting method has been changed, check the different methods used and document the changes in the Audit WorkBench (AWB)-Case Log.
- What items the taxpayer is claiming as deductions.
- All categories of revenue.
- Billing & collection procedures for all sources of revenue through the accounting system; including cash and charge sales and credits.
- The self-assessment or the accrued tax liability procedures.
- Purchasing procedure for inventory, supplies, expenses and fixed assets.
- Accounts payable process including receiving and approving for payment, account distribution, returns, checks and remittance advice as well as cash pay outs.

## **Return Analysis**

Meals taxes are reported on a monthly basis on Form ST-MAB-4. The reporting categories on these returns are as follows:

- Gross Receipts From the Sales of Meals
- Total Charged From Tax Exempt Meals
- Total Taxable Receipts
- Tax

Room Occupancy taxes are reported on Form RO-2 or Form RO-2F. The line items on these returns are as follows:

- Total Rents
- Taxable Rents
- State Tax Due
- Local Tax Due (varies according to city or town)
- CCF Tax Due
- Total Tax Due

Where the taxpayer has maintained all of the proper records necessary, the standard procedures utilized on a Meals or Room Occupancy Tax audit are quite simple. These procedures are intended to verify the accuracy of the line items on the returns.

However, in instances where the taxpayer has failed to maintain adequate records, the auditor must utilize alternative methods to reach a conclusion about the amounts reported by the taxpayer on its returns. Regulation (830 CMR 62C.25.1) was promulgated by the department to indicate all the records required to be maintained by the taxpayer.

Restaurants are for the most part, cash businesses. Cash businesses have always presented taxing authorities with problems in ensuring that the proper receipts and taxes are being reported. The documentation of all sales as well as the proper recording of purchases and other disbursements provide the evidence that the auditor needs to verify the correct amount of taxable sales and taxable income.

### **Examination of Records**

Generally, the records that must be examined:

- Sales Journal
- Purchase Journal
- Cash Register Receipts
- Guest Checks
- Room Folios and Guest Cards (Room Occupancy tax audits)
- Bank Statements
- Income Tax Returns
- If the business is a closely held business, the personal income tax returns as well as the D-Tax account of the owner or owners should be reviewed. The auditor should check for low net income in comparison to large mortgage interest and real estate tax expense. Also, the RMV information for the owner or owners should be reviewed to determine if the income can support their lifestyle.

In performing the audit review, the auditor should reconcile the information available in these records with the tax returns. Standard procedures should be followed in this review, but these procedures should be adapted or expanded depending upon the particulars of the individual case.

### **Daily Sales Journal**

The daily sales journal should be tested for accuracy. Based upon a review of the amounts reported, four months should be selected for this test. The four months should be from different seasons, and different years if at all possible. The columns of the daily sales journal should be added and compared with the amounts which have been reported on the tax return. If any errors are noted, this test should be expanded. A work paper detailing this review should be prepared by the auditor and attached to the AWB

Case.

Once the column totals have been verified, the auditor should compute the tax due for each period of the audit and compare this amount with the taxpayer's reporting of meals or room occupancy tax due. A work paper should be prepared and attached to the AWB Case to document this review.

### **Cash Register Tapes**

Three different periods of cash register tapes should be selected for review. Ten consecutive days should be chosen from each period selected. The periods selected should be included in the months selected for the test of the daily sales journal, one from each of the months.

When reviewing cash register tapes, the auditor should compare the register tape totals to the daily sales journal for each day, noting any multiple ring-outs for the day. Is the total an "x" rather than a "z"? Are there transaction numbers or time of ring-outs which may indicate missing transactions? Is there an unusual number of "no-sales" being rung into the register? Are there more "z outs" than are indicated in the daily sales journal? The auditor should unroll the tapes to check for the above. Is there a tape to coincide with all the registers noted in the auditor's observation? If any inconsistencies are noted in this review, this test should be expanded. Any problems regarding these areas will lead to the determination that the taxpayer's records are inadequate. A work paper must be prepared and attached to the AWB Case to document this review.

### **Guest Checks**

Ten days should be selected for this review. The days selected should be chosen from the days selected for the cash register tape review. The checks should be added and compared with the cash register tape totals and a work paper should be prepared and included in the audit package. The auditor should also review the guest checks in greater detail, noting any problems observed. Are the checks numbered? Are there any checks which are missing? How many waitresses are using the checks and does the number of waitresses coincide with the observation made by the auditor? What menu items are being ordered? This may become important later in the review. Are checks used for all sales? What about bar sales or takeout orders? The auditor should make specific reference about any observations regarding the guest check in the AWB-Case Log. If problem areas are noted, the test should be expanded.

### **Room Folios / Guest Cards**

The review of room folios/guest cards is a step which should be undertaken in room occupancy tax audits. A minimum of ten days should be selected for review. The room folio/guest cards should be traced and reconciled with the daily room rental report. A work paper should be prepared to document this review.

## **Bank Statements**

The bank statements of the business should be reviewed and all deposits scheduled. Any returned checks and cash pay-outs should be reconciled and the schedule must be attached to the AWB Case.

## **Income Tax Returns**

A work paper should be prepared to compare and reconcile any differences noted between the gross receipts reported by the taxpayer on the Income Tax Return (1120, partnership or Schedule C), the total net bank deposits and the gross receipts reported on the meals tax and room occupancy returns filed for the period. This work paper must be attached to the AWB Case.

## **Purchase Journal**

Totals from the purchase journal should be added and compared with the amounts reported on the taxpayer's corporate or personal income tax returns. Any inconsistencies should prompt a more extensive review. The auditor should take note of the name of the vendors and the type of product they sell. Third party verification should be undertaken if there is any suspicion that purchases may be incorrectly accounted. This suspicion is usually due to the auditor's prior observation.

For example, are all menu items reflected in the taxpayer's purchasing? If the taxpayer has an extensive seafood menu, verified through the examination of guest checks, and there is little in the way of seafood purchases, there is a problem. Perhaps these purchases are paid in cash and not recorded. Unusual patterns of purchasing may also be noted and further inquiry could detect additional unrecorded purchases. Any of these factors will shed doubt on the adequacy and correctness of the taxpayer's records.

## **Summary**

The auditor must reconcile information available from the taxpayer's records with the line items in the tax return. Because of the inherent problems associated with cash businesses, the auditor must not simply take these records at face value. The auditor must determine if the taxpayer's records are adequate and reliable through observation of the taxpayer's operations and records. If it is determined the records maintained by the taxpayer are inadequate, the auditor may need to use alternative methods to determine the correct taxable receipts.

## **Alternative Methods**

A taxpayer's records may appear to be complete and correct, when in fact, the taxpayer could be skimming cash from the business and substantially under-reporting the tax liability. The taxpayer could have two cash register tapes which are being posted into the daily sales journal. Cash amounting to the total of these two tapes is deposited into

the checking account. The total of these deposits agree with the amounts reported on the taxpayer's meals or room occupancy tax and income tax returns. The auditor notes the taxpayer's mark-up and it appears to be low. Through observation, the auditor may have noticed that there was another cash register in operation or that there were more employees than indicated in the taxpayer's payroll records. By properly documenting the observation, the auditor has proven that the taxpayer's records are inadequate and this leads into an alternative method to determine the correct sales made by the taxpayer.

If, after conducting a preliminary review of a taxpayer's records, it is determined that the taxpayer's books, papers and other data are inadequate to calculate the proper amount of tax, the auditor may utilize alternative methods to determine the amount of tax liability due.

Alternative methods used by the Audit Division may include bank deposit analysis, mark-up, third party information and any other method that is reasonably calculated to reflect taxes due in light of the facts and circumstances.

### **Bank Deposit Method**

An analysis of bank deposits is used to test the relationship between cash receipts and recorded gross receipts. Use of this method is of value when auditing companies selling predominately taxable items.

There are two methods of estimating gross receipts on the basis of bank deposits:

- Where records of deposits are available for the entire period they should be scheduled for that period.
- Where records of deposits are available only for a portion of the audit period, a percentage of error should be computed and then applied to recorded or reported sales for the remainder of the period.
- The record of cash deposits must be adjusted for the following types of transactions that affect total receipts:
- Increases or decreases in the gift certificates sold and gift certificates redeemed accounts.
- Increases: Cash expenditures and withdrawals from cash receipts before bank deposits are made.
- Decreases: Deposits representing receipts from sources other than sales, i.e., loans, re-deposits of NSF checks, rental income, etc.

If the taxpayer has a record of cash pay-outs, the totals by months should be scheduled. If no such record exists, pay-outs for merchandise sometimes can be estimated by examining the check record or canceled checks to determine which types of merchandise are paid by bank checks.

Credits for loans and increases in capital must be supported by documentary evidence in the form of canceled notes, letters from banks, savings bank books showing withdrawals, etc. The nontaxable receipts must be traced to bank statements to verify

the amount and date of those deposits. Where vending machines are on the premises, copies of statements of settlement from the operators can be used to verify income from these sources. Lottery income and transfers between accounts are also sources of deposits that must be considered in a deposit analysis. The auditor should be alert for evidence of bank accounts for which the taxpayer has not produced statements or deposit books.

### **Mark Up Method**

Mark-up is the difference between gross sales and the cost of goods sold. It is the amount that the goods are marked up in price. Generally speaking, the mark-up is referred to in terms as a percentage of cost of goods sold. To determine this mark-up percentage you would divide the sales price by the cost of goods sold to arrive at your mark-up percentage. Thus, an item with a cost of \$1.00 that is sold for \$3.00 would have a mark-up percentage of 300%.

A mark-up is the amount added to cost to obtain the sales price, and generally is referred to in terms of percentages. The percentage of mark-up (MU) is computed by dividing sales (S) by cost of goods sold (COGS):  $S/COGS = \% \text{ of MU}$ . Businessmen often discuss gross profit in terms of percentages based on sales, but seldom discuss mark-up based on cost. Care should be exercised by the auditor to make certain he is on common ground with the taxpayer when discussing gross profit and mark-up percentages.

Areas of importance in the use of a mark-up method include:

- The determination of total purchases;
- Beginning and ending inventory;
- The segregation of purchases between departments or types of merchandise having the same general level of mark-up;
- Self-consumed merchandise;
- Shrinkage of inventory; and
- Inventory adjustments.

### **Verifying Total Purchases**

Where a record of purchases is available, the monthly or quarterly totals should be tied-in for the entire audit period. These should be proved and the recorded purchases compared with purchase invoices on a test basis to insure that total purchases have been recorded. In many cases, however, a record of purchases will not be available. Under those circumstances, the purchase invoices should be scheduled for a test period. The auditor should conduct sufficient tests to ensure that all purchase invoices are on hand. Recommended procedures are:

- Scrutinize accounts payable for names of vendors with no supporting invoices.

- Ascertain names of brands and types of merchandise carried by a personal inspection of the stock and compare with invoices submitted by the taxpayer.
- Examine canceled checks or check stubs.
- Examine record of cash paid outs.
- Examine vendor's monthly statements for completeness of invoices.

When the auditor is doubtful that all purchase invoices are available, purchases for a test period should be obtained from a representative number of vendors. If it is found that the taxpayer's records are incomplete, some or all of the purchases should be obtained from all vendors records. This procedure should be used in extreme measures only as it is usually very time consuming.

### **Segregation of Purchases**

If there are widely different mark-ups in the various departments or types of merchandise, the purchases, if possible, should be segregated into classes to facilitate the application of appropriate mark-ups. Before adopting this procedure, however, the auditor should make sure that the purchases can be so segregated. If they cannot, an average weighted mark-up applicable to all purchases should be computed.

### **Adjustment for a Change in Inventory**

The auditor must be cognizant of a change in the taxpayer's beginning and ending inventory. A decrease in inventory will increase goods available for sale. Therefore, the sales per mark-up will be greater than the amount determined by marking-up the taxpayer's purchases. Conversely, an increase in inventory will reduce goods available for sale and the subsequent amount of sales determined by marking-up purchases. When breakdowns of the taxpayer's inventories are not available a weighted average amount should be discussed with the supervisor and applied to the change in the taxpayer's inventory.

### **Self-Consumed Merchandise**

The recorded cost of goods sold should be reduced by the cost of merchandise consumed by the taxpayer, if the self-consumed quantities are supported by the taxpayer's records.

### **Shrinkage of Inventory**

In order to recognize the fact that food can spoil or liquor can be spilled a 10% reduction to sales calculated by the mark-up method must be allowed. This allowance is also sufficient amount to cover complimentary meals, complimentary drinks and undocumented employee theft. When the taxpayer claims shrinkage of more than 10%, he must substantiate the amount. This substantiation may consist of reports from

regularly employed security guards, private detective agencies or similar service firms as well as losses computed through sales and inventory reconciliation.

Other substantiation may include the following documents:

- Police reports;
- Insurance claims and settlements;
- Inventory (for fire loss and large theft claims; and
- Type, size and location of store and availability of inventory for pilferage.

When a greater than 10% merchandise shrinkage allowance is given, it should be set out as a separate item.

### **Calculation of Mark-Up**

The accuracy of an audit based on purchases marked up to selling prices depends principally upon two factors; the correctness of cost of sales and the accuracy of the calculation of mark-up. The cost and selling price must be known to compute the mark-up.

This procedure contemplates the auditor will make an actual examination of menus, price tags, price stickers, or any other method used to inform the customer of the unit sales price.

If all items sold are marked up by approximately the same percentage, a straight average may be used. However, if the mark-up on the several classes of purchases varies materially, a mark-up should be computed for each of the classes or a weighted mark-up is computed. The weighted mark-up is usually based on dollar volume of purchases although the units purchased and units sold method may be used to an advantage in certain instances. The most commonly used methods of computing mark-ups are given below in order of preference:

- Weighted average; purchases of one or more purchasing styles;
- Segregation of classes of merchandise; or
- Average of selected items.

Mark-up for periods outside of the audit period may be used when current records are so incomplete as to prohibit establishment of a current mark-up.

Mark-up computations vary in the degree of detail due to the type of establishment being audited, the number of menu items and the records that are available. Generally, the more detailed the computation, the more accurate the computation will be.

Mark-up computations for food sales can be easily performed on an establishment with a limited menu, such as a pizza restaurant, hamburger and hot dog stands, fish & chip restaurants, etc. The more extensive the menu however, the more difficult the

computation becomes. In these instances, several menu items should be chosen and analyzed to determine an average mark-up factor for food items.

All adjustments made before or after computing a mark-up, such as spillage, theft and spoilage should be fully explained and easily understood. The auditor must remember that a hearings officer has no prior knowledge of the case. Once a mark-up becomes somewhat complex or varies from the usual, great care should be taken to explain the method in as simple a way as possible.

### **Flow Through of Adjustments to Gross Receipts**

Any changes to gross receipts as a result of a meals tax audit will usually trigger an adjustment to the taxpayer's corporate or personal income tax returns. These adjustments should be addressed with the taxpayer at the closing conference and the Notices of Intention to Assess for both meals and corporate or personal income taxes should be issued simultaneously. In this way, any appeals can be heard at the same time.

When examining the income tax returns of the business, the auditor should review the deductions claimed by the taxpayer on the 1120 return or schedule C in order to detect items which may be questionable. Items such as unusually high advertising expense or loans from stockholders may raise audit issues.

The auditor should also be alert to detect possible use tax issues. A new restaurant, or one which has undergone renovation, may have purchased furniture and equipment without paying a sales tax. The taxpayer's depreciation schedule should be reviewed to detect such purchases. Generally, unless the taxpayer is a large chain or one of the larger restaurants in the state, use tax on expense purchases would be minimal. In any case, the auditor should document in the audit narrative that this issue has been addressed.

As a standard procedure, the review of a taxpayer's compliance with all other taxes must be performed by the field auditor. Compliance with the filing requirements for withholding, corporate and personal income taxes must be addressed in the audit narrative.

### **Business Segments**

There are many different types of restaurant operations and each type has its own set of peculiarities with which to deal with. The following will point out some of these peculiarities and how the auditor may approach the audit.

#### **Function Halls & Caterers**

- Wedding Announcements (Newspapers)
- Gratuities

- Exempt Functions (Documentation)

### **Pizza Shops**

- Records (inadequate)
- Purchases
- Alternative Methods (boxes, rolls, flour purchases)

### **Donut Shops**

- Nontaxable sales (over 6)
- Alternative Methods (coffee mark-up, bags, boxes)

### **Bars & Taverns**

- Records (inadequate)
- Verification of purchases
- Alternative methods (mark-up of costs)

### **Room Occupancy Tax Issues & Convention Center Financing Issues**

The most frequent issues encountered in room occupancy tax audit are addressed by the following DOR Directives (DD), Technical Information Releases (TIR), Letter Rulings (LR) and Court Cases:

- Rentals for more than 90 consecutive days (See **Lowney v. Commissioner, 67 Mass App Ct. 718 (2006)** and TIR 07-2);
- Airline Rentals (LR 81-108 as modified by Lowney and TIR 07-2);
- Rentals by government employees (LR 80-79 & LR 82-18);
- Rentals by foreign diplomats (DD 88-3);
- Mandatory service charges/gratuities (830 CMR 64H.6.5(7)(a), Chatham Bars Inn, Inc., ATB Docket No.F225093(1998) and DD 99-6 for Room Occupancy;
- Forfeited deposits (LR 85-32);
- Recreational facility charges (LR 86-2 & TIR 89-7);
- Rooms rented to Department of Public Welfare (LR 86-5);
- Complementary rooms (DD 06-7);
- Charitable organizations (LR 81-90 & LR 82-18); and
- Resale of telecommunications services (830 CMR 64.1.6, TIR 99-2 and TIR 91-1).

### **Function Halls & Caterers**

Meals tax audits of function halls and caterers involve several areas not normally encountered in routine meals tax audits. Most function halls and caterers structure their pricing policy so that in addition to the menu price of a meal, a gratuity and/or service

charge is imposed. It is extremely important to ascertain whether or not these charges are paid out, in their entirety, to the service personnel. If any portion is kept by the taxpayer, or is used to subsidize the payroll, the entire charge is taxable. A review of the payroll records is usually necessary to make this determination (830 CMR 64H.6.5).

Another item to be aware of involves charges for the use of a room in which to hold the function. If a separate charge is made for the room and the room is used to serve food, the room rental charge is subject to meals tax. If the purpose of renting the room is for a meeting and only light refreshments are served in the room (coffee, Danish, fruit, etc.), then the room rental charge is not taxable (See LR 79-26, 84-66, 830 CMR 64H.6.5).

These taxpayers are usually where an auditor will encounter the greatest number of exempt sales. The auditor must verify that any sales exempted by the taxpayer are substantiated with the proper certificates. M.G.L. now requires "good faith" in the acceptance of all exempt certificates. The certificates should be reviewed to insure that they are filled out completely and signed. Any incomplete certificates or certificates that are not signed or were not accepted in good faith should be rejected. If the taxpayer does not have certificates for all exempt sales, a sixty day notice should be issued to limit the time that will be allowed for the taxpayer to secure certificates (See LR 84-66, 84-73, 830 CMR 64H.6.5).

"Package Plans" are another area frequently encountered during audits of these types of taxpayers. The important thing to remember about package plans is if the items included in the package are mandatory, the entire package price is subject to meals tax. Package plans usually are wedding packages including flowers, invitations, entertainment, food, liquor, etc. Again, if the customer cannot pick and choose separately priced items that they want, but rather must accept the package in total, the entire charge is subject to meals tax (See 830 CMR 64H.6.5).

If the auditor suspects that all sales have not been reported, it might prove worthwhile to review local newspapers for wedding announcements indicating that the reception was held at the taxpayer's establishment. Once a list has been established, it can be compared to the function invoices or reservation book to determine if all of the parties were reported.

## **Bars & Taverns**

When the proper records are maintained, these are some of the easiest audits to perform due to the limited number of menu items. The problem is that these types of establishments are the ones that most frequently maintain little or no records. When an auditor encounters inadequate records, he/she will be forced to use an alternative method to determine taxable sales. In addition, if it appears that records have been maintained but the sales are still subject to suspicion (mark-up too low or too high, sales too low for size of operation, etc.) an alternative method may still need to be employed. The important thing to remember is case history has shown that if records are

maintained, an auditor has to prove that the records do not accurately reflect the sales of the business before an alternative method can be utilized. One important way to overcome the records is through personal observation (please refer to the section on preliminary analysis).

During observation, an auditor should try to determine the following:

1. **Number of Bartenders on Payroll** - The auditor should note how many bartenders are working. Does the bartender ring up all sales, even for the waitresses? Is more than one register used?
2. **Pouring Practices** - Are the bartenders free pouring or are they using a measure? Do they use a pouring gun?
3. **Sources of Other Income** - Does the bar contain video games, pool table, etc.? If there are machines, are many patrons using them? Does the bar sell anything besides food and liquor such as shirts, hats, etc.?
4. **Door Charges** - Does the bar charge an admission charge? If they do, is a receipt of any type given? Do the customers get anything besides entertainment for the admission charge such as free food or drinks? (See TIR 78-4, 830 CMR 64H.6.5(7)(d)).

Once the decision has been made to use an alternative method, one of the first things to do, is to verify that the purchases shown by the taxpayer are correct. The Audit Division now has a data base containing liquor wholesaler information and supervisors can provide the auditor with the taxpayer's purchase information. Once accurate purchase figures are secured, a mark-up audit should be performed.

The purchases should be recorded by category. The categories should reflect the various selling prices used by the taxpayer. For example, domestic bottled beer, imported bottled beer, draft beer, call liquor, top shelf liquor, etc., will all have different selling prices. Purchases for each price category should then be marked-up by the mark-up attributable for that price category. In order to calculate an accurate mark-up, an auditor must have the correct selling prices and serving sizes.

At the opening conference, the auditor should have the taxpayer supply the selling prices for the audit period and should have the taxpayer sign a certification so that at a later date, the taxpayer cannot argue that incorrect prices were used. The taxpayer should also be asked what his/her serving sizes are. Claims that drinks contain more than 1.5 ounces of liquor should be verified by the auditor.

For example, the following purchases were made by the Taxpayer: 20 cases of Budweiser, 25 cases of Bud Light, 30 cases of Miller Lite, 12 cases of Becks, 15 liters of vodka, and 22 liters of rum. The total cost of all of these purchases was \$3,500. The Taxpayer does not have any records with respect to beginning and ending inventory and is an outstanding filer for corporate excise. Consequently, the figures with respect to beginning and ending inventory are not available. Therefore, we assume all purchases were sold. Under that assumption, sales are computed in the following

manner: First you would compute total beer sales. To do so, you total the number of cases of each type of beer purchased. You would multiply that by 24 to get the total bottles. From that you subtract a 10% waste factor. The resulting number would be the bottles of beer available for sale. Since we have assumed that all purchases were sold, you multiply the number of bottles available for sale by the selling price for that brand.

The following table shows the calculation:

Type of Beer	# of Cases	Total Bottles	10% Waste	Units Available	Selling Price	Sales
Bud	20	480	48	432	\$ 3.00	\$1,296.00
Bud Light	25	600	60	540	\$ 3.00	\$1,620.00
Miller Lite	30	720	72	648	\$ 3.00	\$1,944.00
Becks	12	288	28.8	259	\$ 3.50	\$ 906.50
Total						\$5,766.50

Sales of liquor would be computed in a similar fashion. You would determine the number of bottles of each type of liquor that was purchased. You would then multiply the number of bottles purchased by the number of ounces in a bottle to get total ounces purchased. Again, you would apply a 10% waste factor to arrive at ounces available for sale. Absent any evidence to the contrary, we assume that 1.5 ounces of alcohol are used in each drink. Therefore, you divide the available ounces by 1.5 to arrive at the number of drinks. You multiply the number of drinks for that type of alcohol by its respective selling price.

The following chart shows a simple calculation for two types of alcohol. While there may be many different types of liquor, the calculation is the same. You just need to know the type of alcohol, the brand, and the respective selling price.

Liquor	# Bottles	Ounces/Bottle	10% Waste	Ounces Avail	Total Drinks	Selling Price	Sales
Vodka	15	33.875	50.8125	457.31	305	\$4.00	\$1,220.00
Rum	22	33.875	74.525	670.73	447	\$4.00	\$1,788.00
Total							\$3,008.00

Totaling the projected beer and liquor sales you arrive at total sales of \$8,774.50. This would then be compared to reported sales for the same period. If reported sales were less the discrepancy would be the additional taxable sales. If the Taxpayer sold wine and keg beer additional calculations would have to be made. However, the calculations are similar to the liquor sales whereby you compute the total drinks available and multiply the result by the respective selling price.

Mark-up audits can become very time consuming so an auditor should be confident that a real problem exists before proceeding in this direction. If a mark-up appears to be too low, the auditor should ensure that there is no legitimate reason for the low mark-up before proceeding with a mark-up audit. If no reason for the low mark-up can be found, the auditor should proceed, but only after having substantiated that the records are inadequate as outlined in the sections on preliminary analysis and alternative methods.

## **Pizza Shops**

The pizza business has changed in the last few years with the increase of large chains opening up in all areas. The days of the family owned pizza shop on every corner are diminishing and the audits conducted in this type restaurant have also changed. The meals tax filed by the chains has been found to be generally accurate due to the many internal controls established by the home office or franchises. Their requirement of complete and accurate records along with the internal audits which they conduct has nearly eliminated the need for in-depth audits on this segment of the pizza business. However, not much has changed with the individually owned pizza shops especially in regards to the problems which are commonplace in cash businesses. As previously discussed, a complete review of all records would be conducted including register tapes, guest checks, sales journal, purchase invoices, and Schedule C or Corporate tax returns when available.

The problem arises in conducting these audits when there is an absence of records for the examiner to review and an alternative method must be utilized. The most common method would be to verify the purchases made by the taxpayer during the audit period and applying the appropriate mark-up ratios to arrive at taxable sales. Unlike other establishments where the total purchases, whether they are food or liquor, would be marked-up, the pizza shop audits have the advantage of basing the projected sales on specific purchases of supplies, etc.

The auditor should contact the taxpayer's suppliers to obtain the purchases made of pizza boxes, pizza rounds and grinder rolls. Once these amounts have been secured in writing, adjustments would be made to reflect the opening and closing inventory of the paper products. An average price would be assigned to the pizzas and grinders, based on the taxpayer's menu, and multiplied by the amounts purchased. The pizza rounds are placed in each box to go, but are also used to serve those pizzas which are consumed on the premises. For this reason, both purchases of these paper products must be analyzed to determine the in-store and take out sales.

The grinder roll purchases, which are usually made by cash and records not always kept by the supplier, may have to be determined during the initial audit interview. The auditor should instruct the taxpayer to keep the delivery slips from that point on to arrive at the normal amount purchased for a certain time period. There will be a pattern of deliveries made taking into account that larger orders are received on Fridays and Saturdays to cover the weekends when deliveries are not usually made. Again adjustments must be made to allow for bread purchases which are not sold. It should be

noted that taxpayers will state that excess rolls are thrown away but it is common practice to freeze them for future use. In addition to grinder sales, many pizza shops sell Syrian sandwiches which can also be determined by the corresponding bread purchases.

There are other sales which the auditor should be aware of such as pasta dishes, salads and fish and chip dinners. These items usually make up a small percentage of the total sales but must be taken into consideration. Again the containers that the salad is sold in and the amount of pasta and fish which is purchased will be utilized in determining the accuracy of the sales reported.

The last area to review is that of drinks sold in the pizza shop. The sale of any size beverage which is consumed on the premises is taxable, the sale of unopened original containers 26 ounces or more to go and beverages sold through a vending machine which cost less than \$3.50 are both exempt.

Assume the following facts: A taxpayer purchases 3,000 large pizza rounds, 500 small pizza rounds, 1,000 sub rolls, 500 wraps, 250 salad containers, and 1,000 cans of soda. Unlike a beer and liquor markup, you do not know the exact selling price related to these various purchases. A pizza round could equate to cheese, pepperoni, or some other combination pizza. All of the pizzas have different selling prices. From discussions with the Taxpayer, possibly your observation, as well historical knowledge you should determine the quantity/percentage of each item being sold. From that you can determine the average selling price of each item. For example, if cheese pizzas represent 50% of all pizza sales than the average selling price of pizza would be weighted 50% to the price of a cheese pizza. Thus, assume a price of a large cheese pizza is \$8.00, pepperoni \$9.00 (represents 25% of large pizza sales), and other is \$10.00 (represents 25% of large pizza sales). The average price of a large pizza would be \$8.75 (\$8 times 50% plus \$9 times 25% plus \$10 times 25%). You would then multiply the 3,000 large pizza rounds by \$8.75.

The following table shows the calculation of gross sales:

Item	Purchases	10% Waste	Quantity Sold	Avg. Price	Sales
large pizza	3,000.00	300.00	2,700.00	\$ 8.75	\$23,625.00
small pizza	500.00	50.00	450.00	\$ 5.25	\$ 2,362.50
Subs	1,000.00	100.00	900.00	\$ 5.75	\$ 5,175.00
Wraps	500.00	50.00	450.00	\$ 5.50	\$ 2,475.00
Salad	250.00	25.00	225.00	\$ 5.25	\$ 1,181.25
Soda	1,000.00	100.00	900.00	\$ 1.00	\$ 900.00
Total					\$35,718.75

With the exception of the cans of soda, you would have to determine the average selling price of each item. As the variety of items within a category increase, you might want to take an average of the five most popular items within that category. You also might

have to adjust the price for any documented specials. After accounting for any price adjustments, the average selling price is multiplied by the units sold for that category to arrive at projected sales. The difference between projected sales and reported sales would be the discrepancy.

The procedure listed above is necessary to arrive at sales when sufficient records are not available and should also be utilized to verify the sales when there are records. The taxable sales figures determined by the examiner will not be exact, but in the absence of records our reasonable and fair calculations will be upheld.

### **Notification of Inadequate Records**

After the auditor has calculated taxes due based on the use of alternative methods, the auditor is required to provide the taxpayer with a written statement supporting the auditor's determination of tax liability Notification of Inadequate Records Form.

The notification must be issued upon completion of the audit and prior to the exit conference or the issuance of a Notice of Intention to Assess.

The notification should be hand-delivered whenever possible, and mailed (certified) otherwise. It must be issued to the person designated by the taxpayer to make decisions regarding the conduct of the audit. The designee should be determined during the opening conference.

All notifications given to the taxpayer should be attached in the Audit WorkBench Case.

### **Noticing Requirement**

The form should include sufficient detail for the taxpayer to fully understand the methodology used by the auditor. This usually requires a general reference to the methodology and specific references to the taxpayer's unique circumstances. The notice must include the following information:

- The name of the taxpayer, as shown in the records of the Department;
- The taxpayer identification number;
- The type of tax or taxes assessed;
- The tax period or periods under audit;
- A brief statement indicating the reason(s) for using the alternative methods of determining liability for tax;
- A brief description of the records, if any, upon which the such or alternative method was based;
- A brief description of the alternative method used;
- A brief statement specifying how the alternative method was used to determine tax liability; and
- Any additional information the Commissioner deems appropriate.

## Chapter 9

### Corporation Excise Tax Procedures

**This Chapter is currently under revision.**

## Chapter 10

Financial Institutions

Excise Tax Procedures

**This Chapter is currently under revision.**

# Chapter 11

## Withholding Tax Procedures

### Introduction

The withholding of state income taxes by employers is the single most important revenue source for the Commonwealth. As with all other tax audits, a withholding tax audit is to ensure that the proper amount of tax has been reported, and that the taxpayer is in full compliance with all of the reporting requirements in accordance M.G.L. Chapter 62B.

### Administrative Details

#### Identifying Responsible Person(s)

In order to facilitate the collection of tax liabilities imposed on corporations and partnerships by MGL chapters 62B, 64G, 64H and 64I, auditors must identify the responsible person(s) who are liable for such trustee taxes pursuant to M.G.L. chapter 62C, section 31A and Regulation 830 CMR 62C.31A.1.

The identification of responsible persons must be done for all trustee tax audits. Auditors must document in the audit narrative and Audit WorkBench (AWB)-Case Log the names of the individual(s) responsible for paying over the trustee taxes. This information must also be entered into the MASSTAX system under the taxpayer "NOTE" screen.

#### Bank Account Information

During the course of the examination, the auditor must gather the following information relating to the taxpayer's banking activity:

- Name of bank(s) in which the taxpayer has account(s); and
- Account(s) numbers.

If the taxpayer has more than three (3) accounts, the auditor must get the above information for the taxpayer's three primary accounts. The information must be noted in the audit narrative and documented in the MASSTAX system under the taxpayer "NOTE" screen (See Records Review & Verification Procedures).

#### Bankruptcy Information

When a taxpayer files the bankruptcy case, the automatic stay prohibits all of the taxpayer's creditors, including the Department of Revenue, from taking any action to collect any debts or liabilities that relate to the time period before the Petition Date.

During the course of the initial taxpayer contact, the auditor should ask the taxpayer if they are in bankruptcy. If the taxpayer is in bankruptcy, the auditor must obtain the following information and forward it to the Litigation Bureau's Bankruptcy Unit immediately:

- The location of the Bankruptcy Court;
- The Bankruptcy Court docket number (stamped on the bankruptcy petition); and
- The petition date (the date the bankruptcy case was filed).

The information must be noted in the audit narrative and Audit WorkBench (AWB)-Case Log to ensure the necessary steps are taken to contact the Bankruptcy Unit in a timely fashion.

**Note: Bankruptcy procedures are discussed in detail within Chapter 6-Specialized Audit Procedures of the Field Audit Procedures Manual.**

## **Case Plan**

The Audit WorkBench-Case Plan will be used to guide the progression of each case. The case plan is structured to allow for flexibility of workflow and is broken into primary tasks and subtasks. When all of the subtasks are completed in a certain primary task, it will automatically be entered in the Audit WorkBench (AWB)-Case Log.

## **Withholding Tax**

### **Overview**

Withholding refers to income tax withheld from wages by employers to pay employees' personal income taxes. An employer is required by law to withhold Massachusetts personal income tax from wages of residents for services performed either within or outside Massachusetts, and from wages of nonresidents for services performed in Massachusetts.

An **employer** is any person, corporation or organization for which an individual performs a service as an employee. An employer may be an individual, corporation, partnership, estate, trust, association, joint venture or other incorporated organization. Religious, educational, charitable and social organizations also may be employers. Employers are responsible for collecting and remitting employee withholding to the Commonwealth.

All employers with 11 or more full-time equivalent employees are required to offer, as part of the Health Reform signed into law on April 12, 2006, a Section 125 Plan that meets Health Connector regulations. The Commonwealth HealthCare Insurance Program is run by the Health Connector which connects eligible Massachusetts residents with approved health plans and helps them pay for them. Section 125 Plans let employees save money through pre-tax payments for health coverage.

Massachusetts adults must show that they have enrolled in a health insurance plan or lose their personal income tax deduction on their 2007 state taxes.

An **employee** is anyone who performs services for another person or organization under the direction and control of that person or organization. The relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the details and manner in which the job is to be accomplished.

In accordance with MGL, Chapter 62B, the status of workers as employees or independent contractors for wage withholding purposes is governed by Section 3401 of the Internal Revenue Code (IRC). The Commissioner will accept determinations of employee or independent contractor status based on the Internal Revenue Service for purposes of identifying income tax withholding obligations under Chapter 62B (See Technical Information Release 05-11).

The classification of individuals in the workplace is an important issue with many challenges facing the Commonwealth. Entities that misclassify individuals take away tax revenue from the Commonwealth that the state would otherwise receive from payroll taxes. Misclassified individuals do not access to employer provided healthcare coverage and may be paid reduced wages or cash as wage payments.

Businesses that follow all of the relevant statutes regarding employment are at a disadvantage when bidding for the same work, customers or contracts as those businesses that do not follow the same rules. Misclassification significantly reduces fair competition and negatively impacts the business environment in the Commonwealth and results in subsidizing those businesses that do not follow the Law, in essence, businesses that follow the Law and pay the proper taxes and insurance do so having a distinct competitive disadvantage.

As a general rule, the owner of a sole proprietorship is not considered an employee for withholding purposes even if he or she has no other employees. Accordingly, the owner would not register for withholding solely to pay his or her own taxes.

If an owner expects to owe more than \$400.00 in Massachusetts income tax on the income received from the business, he or she is required to make individual estimated income tax payments.

Information on individual estimated income tax payments can be found on the Web Services for Income section of our website at [www.mass.gov/dor](http://www.mass.gov/dor), or DOR's Estimated Income Tax Payment Voucher (Form 1- ES) instructions.

An employer's responsibilities under the withholding tax are listed below:

- Registering with the Department to collect withholding taxes;

- Withholding state income taxes from employees who reside or are employed in Massachusetts and remitting those taxes, along with the appropriate form on time.
- Obtaining from each employee a completed Employee's Withholding Allowance Certificate (Form W-4) and Massachusetts Employee's Withholding Exemption Certificate (Form M-4) included on the form is the employee's full name, home address, Social Security number, the total number of exemptions, and any additional withholding amounts the employee requests to have withheld;
- Submitting to the Department a completed copy of the Form W-4 from all newly hired personnel, or personnel returning to the payroll after 30 days or more off the payroll and independent contractors who will be earning \$600 or more, within 14 days of hire or reinstatement. Reports may be made via DOR's Online New Hire Reporting System, available on the DOR website at **[www.mass.gov/dor](http://www.mass.gov/dor)**.

This information is matched to DOR's database of individuals required to pay child support. When a newly hired employee or independent contractor has a child support obligation, DOR notifies the employer to withhold child support and remit the funds to DOR for distribution to families entitled to support. Employers must remit these funds within three business days of the payroll date.

The information also is used to combat fraud in programs run by various state and federal agencies by:

- Providing each employee with a Wage and Tax Statement (Form W-2) by January 31, or within 30 days if employment terminates before the close of the calendar year, showing the total amount of wages paid, the total Social Security and Medicare taxes withheld, and the amount of Massachusetts income tax withheld for the prior year.
- Contacting the Massachusetts Division of Unemployment Assistance to fulfill the obligations for state employment security taxes.
- Contacting the Internal Revenue Service (IRS) to fulfill obligations for withholding federal income taxes as well as Social Security and Medicare taxes.
- Providing DOR with Form W-2 on magnetic media if you have 250 or more employees as required by the Internal Revenue Service (IRS). This must be filed with the Department by the last day of February for the preceding year. Employers can use the WebFile for Business "Report Wages/File Upload" option to report W-2 filed, instead of mailing the magnetic tapes, cartridges or diskettes to DOR.
- Filing quarterly reports of wages paid to each employee who resides or is employed in Massachusetts. This filing is done online through DOR's WebFile for Business program, or on Employer's Quarterly Report of Wages Paid (Form WR-1). The information may be recorded on magnetic tape, diskette or cartridge. Employers with 50 or more employees must submit wage reports electronically (See Technical Information Release 04-30). The purpose of the wage reporting system is to verify eligibility for programs such as Welfare, Medicaid, unemployment compensation and workers' compensation. In addition, it is used

to help track down parents who fail to pay the child support they owe. Requirements under this system are separate from requirements to submit income tax withholding forms.

An employer is required to withhold taxes on wages paid to a nonresident for services performed in Massachusetts. However, if a nonresident does not work in Massachusetts, withholding is not required even if they are paid from a Massachusetts office.

A non-Massachusetts employer must deduct and withhold from wages the amount determined for Massachusetts income tax purposes, less any amount deducted and withheld for the employer's state. If there is no state withholding in the home state of the business, the employer withholds and remits the full amount determined for Massachusetts.

A non-Massachusetts employer is not required to withhold if the only Massachusetts connection is the employment, outside Massachusetts, of a Massachusetts resident. The employer may withhold for the convenience of the employee if both employer and employee agree. The employee will owe Massachusetts income tax if the employer does not withhold state income taxes.

Generally, since the Department follows the Internal Revenue Service guidelines for persons subject to withholding, if there is no requirement to withhold federal income tax, because of type of income, there is no requirement to withhold Massachusetts income tax. In particular, withholding by household (domestic) employers is not required. However, domestic employers still are required to withhold Social Security tax from household employees.

Tax-exempt organizations such as religious and government organizations are required to withhold income tax from employees.

### **Withholding Tax on Performers and Performing Entities**

Performers and Performing Entities are individuals or groups of individuals who earn income connected with Massachusetts for performances, whether those performances are of an athletic, entertainment or educational nature, may be subject to withholding on that income. The performing entity's legal classification does not affect the withholding requirement whether it's a corporation, partnership, limited partnership, or any other legal entity.

The performer withholding agent is determined based on the following: the venue where the performance takes place, if the venue or its lessee is/is not a party to contract with the performer or the performing entity, if the promoter is/is not party to the contract, or the withholder may be a vendor or a payroll service. The DOR will assist taxpayers in determining the performer withholding agent if those in a position to withhold clarification as to their withholding responsibility.

Performers and performing entities are not required to have withholdings if the gross payment for one performance per calendar year by one payer does not exceed \$5,000.00 (See DOR Directive 05-4).

Performers and performing entities requesting and receiving a waiver of withholding are granted under the following circumstances:

- Performer is a resident of Massachusetts and has paid all of his/her Massachusetts taxes to date;
- Performer is treated as an employee of the withholding agent or performing entity for federal income tax withholding purposes;
- Performing entity maintain an office in MA and does not have any outstanding MA tax obligations;
- Performing entity is registered with DOR for Withholding taxes as an employer; or
- Performer or performing entity anticipates that there will not be sufficient income to subject then affected performer(s) to personal income tax in Massachusetts, not more than \$8,000.00 including sources from inside and outside of Massachusetts.

In accordance with the Internal Revenue Code (IRC), federally tax-exempt 501(c)(3), entities are required to withhold if the gross payments to all performers or performing entities that are subject to withholding under the performer withholding regulation, excluding payments for which withholding had been waived, exceed \$10,000.00 for a particular performance, event, program or series. If the gross payments made by the 501(c)(3) entity to a performer or performing entity for performances during one calendar year does not exceed \$5,000.00, then withholding is not required.

### **Performer Withholding Agent**

In order to comply with its obligation as a withholding agent, performer withholding agents must:

- Register using DOR's WebFile for Business(WFB) website, under Performer Withholding;
- Report and pay the amount of taxes withheld during a quarter-monthly period which is defines as the first seven days of a calendar month, the eighth through the 15th day of a calendar month, the 16th through the 22nd of a calendar month, or the 23rd through the last day of a calendar month;
- Reconcile all amounts withheld during the calendar quarter and file a quarterly return before the last day of the month following the close of the calendar quarter, even if the withholding agent has no withholding for the quarter;
- Issue federal Forms 1099-MISC and Form 1042-S (for foreign, non-U.S. person) to any performer or performing entity to whom the withholding agent makes a payment;

- File federal Form 1099-MISC with DOR on or before June 1st of each year if it has made a payment of Massachusetts source income to a nonresident individual in accordance with nonresident personal income tax regulation; and
- Maintain records including the name and social security number of the performer or performing entity, the gross amount paid to the performer or performing entity, the amount of Massachusetts income tax withheld, and the dates and locations of all performances.

## **Performing Entity**

The performing entity must maintain records of the withheld tax through the following:

- Allocate the tax among its member by completing Form PWH-WA, Withholding Allocation Form;
- Supply the form to each of the performing entity's members or participants. All taxes withheld must equal the sum of the allocated taxes to all of the participants of the performing entity;
- Retain copies of notices where DOR permission for reduced or waived withholding has been granted; and
- File and pay Massachusetts corporate excise tax if the performing entity is a corporation.

## **Performer**

An individual performer can claim the withheld amounts as credits towards his/her tax obligation of his/her Massachusetts personal income tax return (Form 1 or Form 1-NR/PY).

The performer must do the following in order to take the appropriate credit:

- Attach a statement of the amount withheld to his/her Massachusetts personal income tax return;
- Supply Form 1099-MISC or Form 1042-S if the performer was paid as an individual by the Massachusetts performer withholding agent; or
- Supply Form PWH-WA if the performer was part of a performing entity.

## **Taxable Wages and Filing Requirements**

Taxable wages include all compensation to an employee for services performed. Payments subject to Massachusetts withholding include wages, salaries, tips, commissions, bonuses, fees or any other item of value paid to an individual for services performed as an employee. It is also important to note:

- Payments of pension, annuity and other similar payments made to Massachusetts residents who have not elected to be exempt from U.S. income tax withholding are subject to Massachusetts income tax withholding.

- Lump sum and eligible rollovers that are subject to federal withholding are also subject to Massachusetts withholding, unless such distributions are of a type that would never be subject to Massachusetts income taxation (See Technical Information Release 02-18 and Technical Information Release 93-3).

The amount of income tax withheld is based on the employee's taxable wages and the number of exemptions claimed, and any additional withholding amounts requested on the Massachusetts Employee's Withholding Exemption Certificate (Form M-4). Withholding is calculated either by using the tax tables available from the Department or by using a mathematical formula known as the percentage method. These methods, which are explained in Income Tax Withholding Tables Effective January 1, 2012 (Circular M), may be applied on a daily, weekly, biweekly, semi-monthly or monthly basis.

The current tax rate to apply to taxable wages is 5.25%.

The following table puts forth the filing requirements and payment schedules for withholding tax:

<b>Withholding Tax</b>		
<b>Projected annual Withholding tax Collected from all Employees</b>	<b>Return Filing Requirement</b>	<b>Payment Due</b>
\$100 or less*	<b>Annually</b> due by January 31 of the following year.	Payment due with return.
	<b>WebFile for Business or Form M-941A.</b>	
\$101 up to \$1,200*	<b>Quarterly</b> due on or before the last day of month following close of calendar quarter, 1.e., on or before April 30, July 31, October 31, and January 31.	Payment due with return.
	<b>WebFile for Business or Form M-941.</b>	
\$1,201 up to \$25,000*	<b>Monthly</b> due on or before 15 <sup>th</sup> day of the following month except for the payments for March, June, September and December-These are due on last day of the following month.	Payment due with return.
	<b>WebFile for Business of Form M-942.</b>	

More than  
\$25,000\*

**Quarterly** due on or before last day of  
Month following the close of the  
calendar quarter - i.e., on or before  
April 30, July 31, October 31 and  
January 31.

When Massachusetts income  
tax withheld is \$500 or more  
by the 7<sup>th</sup>, 15<sup>th</sup>, 2<sup>nd</sup> and last  
day of a month, pay over  
Within three business  
days thereafter.

**WebFile for Business.**

\* Employers and businesses with a combined annual withholding, sales/use tax (including sales tax on meals and telecommunications services) and room occupancy excise liabilities of \$10,000 or more are required to file returns and make payments electronically. Once the tax liability reaches the electronic filing threshold in one year, the business must file electronically in all subsequent years, regardless of the amount due, as long as it has an obligation to file one of these three categories of taxes in Massachusetts. Businesses that register on or after September 1, 2003, must file returns and make payments electronically, regardless of the amount of their annual tax liability. Also, all zero tax due returns are required to be filed electronically, regardless of the amount of their tax liability. All payroll service providers (third-party bulk filers) are required to file and pay withholding taxes electronically for all returns.

An electronically filed return or report is deemed timely filed if electronically submitted on or before the due date, before midnight Eastern Time with all required information accurately entered. Upon submission, the filing entity will receive a confirmation number and time-and date-stamp, which constitute the substantiating date mark providing proof of time and filing date.

In order to be considered timely, a paper return must be received by DOR on or before the due date, or if sent by U.S. mail and delivered after the due date, it must be postmarked by the U.S. Postal Service at least two days prior to the due date.

### **Potential Audit Referral Information**

The Wage Enforcement Unit (WEU) performs withholding tax audits on businesses and individuals that violate the Commonwealth's personal income tax and employment tax statutes by failing to pay all required payroll and other income tax withholdings to DOR.

In an effort to bring these taxpayers into compliance, taxpayers that fall into the following fact patterns should be referred to WEU or examined as part of an ongoing audit:

- Businesses that are not withholding tax properly (particularly non-registrants).
- Businesses that are paying workers "Under the Table" (restaurants, contractors, landscapers, etc.).
- Out-of-state contractors that are not complying with MA tax laws (particularly withholding, income and corporate).

- Businesses engaged in fraudulent employment activities (not paying workers for services performed).
- Observation that a company under audit has employees but is not registered for WH or appears to be underpaying withholding.
- Businesses that deal in cash and other "off-the-books" schemes to conceal their activities and true tax liability (BODA lifestyle, embezzlement and other wage/illegal activity type cases).
- Businesses that misclassify employees as independent contractors.
- Articles in local newspapers/publications that identify specific companies engaged in fraudulent employment activities.
- Businesses located outside of MA and are not complying with MA withholding laws.
- Businesses that use Western Union (or other services) to transfer excessive amounts outside the country.
- Corporations that list salaries and wages (Form 1120, line 13) or compensation of officers (Form 1120, line 12), but do not file the appropriate withholding with MA.
- Schedule C businesses that list wages (Schedule C, line 25) or cost of labor (Schedule C-1, line 3), but do not file the appropriate withholding with MA.
- Any Voluntary Disclosure WH cases that the Voluntary Disclosure Unit might receive.

In addition, for any BODA, NEAB and Multistate withholding tax case, the proper generic/specific codes in Audit WorkBench (AWB) to properly track the audit.

## **Opening Conference**

The purpose of the opening conference is to obtain any information, which will be necessary to complete the examination. Since the payroll in many businesses is by far the largest operating cost, the preliminary discussions should involve an understanding of the internal controls that the company has in place. The following are suggested questions that should be asked:

- Are employees paid by check?
- Is a payroll bank account maintained?
- Are the activities of time keeping, payroll compilation, payroll check signing, and paycheck distribution performed by separate departments or employees?
- Are all operations involved in the preparation of payrolls subjected to independent verification before the payroll is distributed?
- Are employee time reports approved by supervisors?
- Is the payroll bank account reconciled monthly by an employee having no other payroll duties?
- Who is responsible for preparing withholding tax returns and remitting payments, and are they subject to review?

## **Records Review and Verification Procedures**

Generally the records to be reviewed are as follows:

- Payroll Journal and Recap Sheets
- Federal 940, 941 & related Massachusetts returns & forms (M-941; M-941A; M-3; M-3M; M-3P;
- WR-1)
- Fringe Benefit Records
- Payroll Check Register
- Income Tax Returns
- Wage Statement (W-2)
- Exemption Certificate (W-4) & related Massachusetts forms (M-4; M-4P)
- Canceled Checks or Electronic Funds Transfer
- Corporate Officer and Bank Account Information

### **Payroll Journal and Recap Sheets**

Three kinds of payroll journals are usually used by employers: hourly, salary and confidential. A confidential payroll may be kept for corporate officers, and an auditor should always check to see if one is maintained. The payroll journal must be checked for accuracy by footing several months of activity. In addition, tracing names and wage or salary rates to records maintained by the personnel department can be useful in verifying the journals accuracy.

Recap sheets are often used in conjunction with the payroll journal as a summation, and are often used in preparing the monthly or quarterly payroll. Recap sheets must also be checked for accuracy by tying them into the payroll journal. Recap sheets will show wages, federal and state taxes and FICA deductions.

### **Federal 940, 941 & Massachusetts M-941; M-941A; M-3; M-3M; M-3P; WR-1**

**Federal 940** is Employees Annual Federal Unemployment Tax Return which reports the total payments as salaries, wages, commissions, taxes, bonuses, vacation allowances, amounts paid to part-time employee, value of goods, lodging, food clothing and non-cash fringe benefits.

**Federal Form 941** is the quarterly return form which combines the reporting of income and FICA taxes withheld from wages, annuities and supplemental unemployment compensation benefits.

The figures on these reports and the payroll journal should be tied in order to determine the accuracy of payroll records.

Reconciliation between Federal and Massachusetts returns should be done on a period by period basis. All differences should be accounted for. If differences occur due to an employee being a nonresident, addresses should first be checked to the Personnel

department. It is also important to obtain a job function for all nonresident employees who might perform services both within and without the Commonwealth.

### **Fringe Benefits**

The auditor should look into the fringe benefits, including personal use of a car, personal travel, and meals provided by company. These fringe benefits are part of wages, which are subject to the withholding tax. Fringe benefits might apt to occur for sales personnel and executives, who are required to travel and do promotional type of activities. If an employer provides employees with qualified transportation in a commuter highway vehicle, such as a van or bus, the value of the transportation is not income to the employee.

If there is a discrepancy on withholding tax payments, the auditor must verify by the canceled check. This is the only verifiable proof of payment.

### **Payroll Check Register**

Payroll checks are usually recorded on a payroll register. This record can be used to verify that each employee received a payment of wages after all deductions are made.

### **Income Tax Returns**

Examine income tax returns and ascertain that all amounts being claimed as deductions are being reported as wages subject to withholding. These would include standard line items for salaries and wages; officer's compensation; manufacturing wages included in Cost of Goods Sold; fringe benefits listed in other deductions; and pension and annuities. Once the total claimed a deduction is ascertained, tie them into the payroll and reporting forms.

### **Wage Statement (W-2)**

W-2's issued by the employer are based on the payroll journal. Once again a check should be made to tie these records together. Total tax withheld on W-2's should be tied to the recap sheet. If there are discrepancies that cannot be accounted for, the larger amount of tax due should be used from either the recap sheet or the W-2.

### **Exemption Certificate (W-4)**

All employees must file an exemption certificate with his or her employer showing the number of exemptions to which he or she is entitled. The auditor should always check to see if the employee has claimed an excessive number of exemptions or an exempt status. An employee is not allowed to claim more than 10 exemptions.

## **Canceled Checks**

If there is a discrepancy on withholding tax payments, the auditor must verify by the canceled check. This is the only verifiable proof of payment.

## **Electronic Funds Transfer**

Electronic filers must also make payments under the Electronic Funds Transfer (EFT) program imposed under G.L. c. 62C, section 85 and 830 CMR 62C.78.1. The regulation permits modification of the EFT program by providing that "any further expansion of the EFT program will be announced in advance by Technical Information Release (TIR) or other Department of Revenue public written statement." 830 CMR 62C.78.1(3)(b)(6). Any thresholds or procedures established under the EFT regulation that differs from those announced here are hereby modified. While electronic filers must make payments under EFT, filers may be required to make payments under the EFT program without being required to file electronically. A filer that must file and/or pay one type of return or tax by electronic means is not necessarily required to use electronic means for other returns or payments, unless a separate electronic requirement applies.

## **Corporate Officer and Bank Account Information**

The auditor must obtain the name and social security number of the corporate officer who is responsible for the payroll. In the case of an assessment, these corporate officers can be responsible for the withholding tax liability of their employer (See Administrative Details).

# Chapter 12

## Miscellaneous Excise Tax Procedures

### Gasoline Tax Audit Procedures

#### Introduction

Chapter 64A of the General Laws imposes a tax on Gasoline, which is reported on a monthly return Form GT-456. There are three types of license holders: (1) distributor, (2) unclassified importer, and (3) unclassified exporter.

The primary purpose of the gasoline tax audit is to confirm that the taxpayer has reported the correct amount of tax based on net taxable gallons.

#### Administrative Details

##### Identifying Responsible Person(s)

In order to facilitate the collection of tax liabilities imposed on corporations and partnerships by MGL chapters 62B, 64G, 64H and 64I, auditors must identify the responsible person(s) who are liable for such trustee taxes pursuant to M.G.L. Chapter 62C, section 31A and Regulation 830 CMR 62C.31A.1.

The identification of responsible persons must be done for all trustee tax audits. Auditors must document in the audit narrative and Audit WorkBench (AWB)-Case Log the names of the individual(s) responsible for paying over the trustee taxes. This information must also be entered into the MASSTAX system under the taxpayer "NOTE" screen.

##### Bank Account Information

During the course of the examination, the auditor must gather the following information relating to the taxpayer's banking activity:

- Name of bank(s) in which the taxpayer has account(s); and
- Account(s) numbers.

If the taxpayer has more than three (3) accounts, the auditor must get the above information for the taxpayer's three primary accounts. The information must be noted in the audit narrative and documented in the MASSTAX system under the taxpayer "NOTE" screen.

## **Bankruptcy Information**

When a taxpayer files the bankruptcy case, the automatic stay prohibits all of the taxpayer's creditors, including the Department of Revenue, from taking any action to collect any debts or liabilities that relate to the time period before the Petition Date. During the course of the initial taxpayer contact, the auditor should ask the taxpayer if they are in bankruptcy. If the taxpayer is in bankruptcy, the auditor must obtain the following information and forward it to the Litigation Bureau's Bankruptcy Unit immediately:

- The location of the Bankruptcy Court;
- The Bankruptcy Court docket number (stamped on the bankruptcy petition); and
- The petition date (the date the bankruptcy case was filed).

The information must be noted in the audit narrative and Audit WorkBench (AWB) - Case Log to ensure the necessary steps are taken to contact the Bankruptcy Unit in a timely fashion.

**Note: Bankruptcy procedures are discussed in detail within Chapter 6-Specialized Audit Procedures of the Field Audit Procedures Manual.**

## **Reporting Categories**

Reporting categories are broken out as follows on the gasoline tax return:

- Inventories/Receipts;
- Distribution;
- Tax Computation;
- Schedule X-R (Receipts); and
- Schedule X-D (Disbursements).

Audit procedures used in each audit situation will be adapted to the individual taxpayer's system of accounting and record keeping. Since different reporting methods are used by taxpayers to complete gasoline tax returns, it is important that the auditor understand the method utilized by the taxpayer. The auditor should complete an analysis of the accounting system and devise specific audit procedures applicable to the audit. Certain procedures must be performed on each audit (i.e. inventory analysis, distribution verification, receipts reconciliation, etc.).

## **Types of Gasoline Audits**

### **Distributor**

The standard approach for auditing a distributor is to verify the accuracy of each line item of the Gasoline Tax Return that is completed by the taxpayer. This involves examining the records for inventory, the receipt of gasoline imported from out-of-state

and fuel acquired within the state, as well as verification of tax paid purchases. After completing this phase, the auditor should conduct the distribution check. This covers out-of-state shipments of gasoline with particular attention given to transporting methods and the status of the purchasers.

This is followed by the check of tax-free sales to other licensed distributors and the United States government and verification of taxable sales including own usage. The remaining audit steps include verification of the figures of the loss and gain adjustment and the credit for tax payments.

### **Unclassified Importer**

While auditing an unclassified importer, the auditor should concentrate on checking the gasoline purchases. The amount of fuel imported into the state is the amount taxed in every instance. The auditor must substantiate that gasoline purchased from within the Commonwealth includes the fuel's excise tax. They must also check that tax free sales, out-of-state deliveries and adjustments for gain or loss of fuel is not used as a reduction to the excise due on the gasoline imported.

### **Unclassified Exporter**

The audit of a holder of a license as an unclassified exporter mandates a plan to check that all of the fuel purchased was exported (Chapter 64A, section 8A states, "A distributor may sell fuel tax-free to any person who is a licensed distributor in another state provided that the entire quantity is to be exported forthwith from this Commonwealth prior to use or resale and provided, further, that such person is licensed by the Commissioner as an unclassified exporter"). The auditor performs this verification by examining copies of the fuels tax returns filed with the state where the gasoline was exported. They also must check delivery documents and transportation charges.

If the unclassified exporter makes sales of gasoline in the Commonwealth, generally the fuel purchased for these transactions is from a source within this state; therefore, the purchase price should include the tax since the gasoline was not exported. Billing statements should be checked to confirm that the excise tax was charged.

### **Analysis of Taxpayer Reporting Method**

During the opening conference, the taxpayer or the taxpayer's representative should explain the reporting method utilized. The auditor should ask open-ended questions to obtain an overview of the entire operation of the business and also identify probable problem areas of tax liability.

Consider the following areas:

- The step-by-step process by which the information is obtained and summarized to prepare the return.
- This information should include the records used to prepare the return.
- General ledger accounts and work papers used to prepare the returns. The auditor should check for related accounts when the Chart of Accounts is reviewed.
- Changes in personnel who prepared the returns. Obtain the name and position of anyone who prepares a specific portion of the return.
- Verification of receipts.
- Tax paid purchases.
- US. Government and Foreign Consulate Sales & other tax-exempt sales such as those to the Port Authority, MWRA, Transit Authorities and the MBTA (see further explanation under "Other Non-Taxable Distributions").
- If the reporting method has been changed, check the different methods used and document the changes on the audit plan.

### **Internal Control Overview**

The taxpayer's system of internal control must be analyzed and evaluated to determine the reliability of the records being examined. The depth of the audit examination is determined in great part by the reliability of the taxpayer's internal control system. Each system must be analyzed for specific strengths and weaknesses. Some characteristics of good internal controls are listed below:

- A clearly defined separation of responsibility for each function;
- An adequate system of authorization;
- Adequate supervision of duties;
- Adequate documentation;
- Internal audit verification system;
- Segregation of duties;
- Operating Procedures Manual; and
- Independent verification of the prepared financial statements by a Certified Public Accountant firm.

### **Inventory**

Inventory is best examined by verifying each line item of the Inventories/Receipts section of the gasoline tax return.

Generally, verification of inventory includes:

- Determining if the inventory is book or actual;
- Checking meter readings and stick readings for accuracy;

- Spot checking receipt of large quantities of gasoline;
- Checking for inventory in transit;
- Determining product in tanker/barge, or in a dock/inlet facility;
- Determining any product on consignment to others;
- Determining that the last month's closing inventory agrees with the next month's opening inventory;
- Determining whether the closing inventory, at any time, exceeds the taxpayer's storage capacity; and
- Verifying if there is an indication that the closing inventories keep growing over a period of time, which may indicate postponement of tax reporting and payment.

## **Work Papers**

Inventory work papers should include the following information:

- Date of inventory taken and by whom;
- Each location;
- Tank number and capacity;
- Type of fuel stored;
- Pump meter readings, if any;
- Stick readings; and
- Quantity in actual gallons.

If the inventory records are not of the opening dates of the tax return, it is necessary to adjust to that date so that the summary of the total fuel stored agrees with the tax return.

The records for the opening inventory reported for the first day of the audit period and the closing inventory of the last month in the audit must be verified. The actual inventory of fuel on hand, and the pump meter readings, must be taken and recorded in the audit work papers. This is usually done at the initial tour of the facilities.

If the audit uncovers inventory errors and it is necessary for the examiners to take physical inventory, it should be taken in the presence of the taxpayer's principal officer, owner or partner who will be asked to sign a statement that a physical inventory was taken in his/her presence, the date it was taken and the amount of fuel on hand as indicated on the inventory work papers. This is an important part of the audit and it must not be omitted.

The inventory control records of the last date of a test month must be examined in detail to determine if the fuel withdrawn from storage was entered and reported in the sales of that month. Taxable sales are not to be reported by the billing cycle, which method often postpones timely payment of the excise.

## **Purchases**

The purchase of gasoline is reported in the tax return, Form GT-456, as a "receipt". Purchases are classified in different categories and each category's transactions are recorded in Schedules 1 - 5 of the tax return. Purchases may be either on a tax-paid or non-tax paid basis, depending on the license status of the taxpayers, the origin, and destination of the gasoline purchases, the method of transportation used in shipping it and any specific contractual agreements between purchaser and seller.

The examination process includes:

- Checking license status of the purchaser (taxpayer) and the vendors from whom gasoline was purchased;
- Checking the entries in Schedules 1 - 5 with reciprocal reports received from the sellers and from other jurisdictions if purchases were from out-of-state;
- Noting the volume fluctuations of gasoline, seasonal or otherwise; and
- Noting patterns of purchase sources and type of transactions reported during the audit period.
- The verification of purchases requires performing the following:
- Analyzing and evaluating the taxpayers purchasing system for;
  - Control of purchase invoices and related documents;
  - Recording of purchases in the journals, ledgers and accounts; and
  - Payment of the gasoline acquired.
- Checking if all purchases were made by authorized department and approved by responsible person;
- Evaluating the system of internal controls to determine reliability of records;
- Verifying purchase order journal to verify purchases made and reported in the tax return receipt schedules;
- Confirming tax return receipt schedule entries in:
  - Purchase journal;
  - Inventory control records;
  - Transportation charges;
  - Computer printouts for gasoline purchases; and
  - Computer codes for gasoline purchases.

## **Tax Paid Purchases**

If taxpayer reports tax-paid purchases, the auditor confirmation requires:

- Reviewing the returns filed by the vendor selling the gasoline to check whether the transaction was reported as a tax-free sale;
- Examining purchase invoices for an excise charge;
- Tracing the tax-paid purchase accounts payable journal to the ledger account;
- Checking cash disbursement for amount paid on the tax-paid purchase; and

- Verifying account ledgers for possible credit entries which may be offsets for the tax charge. Such credit entries generally are dated several months after the transaction was made.

In the examination of the purchase invoice attention should be directed to examining:

- Delivery ticket associated with the purchase invoice;
- Custom certificates, if imported outside the United States;
- The method of transportation used, i.e. tank wagon sizes usually determine the quantity delivered;
- Storage tank receiving books;
- Inventory control records;
- The amount reported at "net"/60 temp. degree or "actual"/gross gallons;
- Price charged for the product;
  - Note price/gallon and relation between the gallonage and the total amount charges;
  - If tax is included in the price; and
- Note any remarks relating to cash payment or credit and trace to associated book entries.

### **Direct Delivery Shipments**

The auditor must examine sales journals and customer accounts for "direct" delivery shipments of gasoline that may not be in the purchasing records.

Invoices must be reviewed to determine if they contain instructions to deliver the purchased gasoline "direct" to a customer or taxpayer's station(s) and not to own terminal storage tanks. Check all such deliveries to the purchase books and tax return schedules. The auditor must verify that all "direct" delivered purchases are deemed sales which are taxable.

The examination of the following books is required:

- Product control records;
- Purchase contracts;
- Receiving records;
- Exchange agreements;
- Terminal reports;
- Purchase orders;
- Purchase journal, exchange journal;
- Accounts payable, notes payable ledger;
- Voucher register;
- Cash disbursement journals;
- Inter-company journals; and
- Company owned/leased/operated service station books.

## **End of Month Purchases**

The auditor should verify that end of month purchases are not postponed to following month's tax return but are reported in the month title passed.

## **Unreported Purchases**

Audit work papers for unreported purchases should state:

- The date of purchase;
- Name of seller and address;
- Purchaser's name and address;
- Quantity (gallons) gasoline purchased;
- Price per gallon;
- Tax rate/amount, if any, charged;
- Total price;
- Transportation company;
- Place where delivered;
- Purchase invoice number;
- Delivery ticket number if different from purchase invoice;
- Drivers of truck delivery; and
- Signature (name) of receiver (which may be different than purchaser's name).

Unreported purchases or errors uncovered are listed and explanations are requested. Unsatisfactory explanations require summarizing the purchased amount of gasoline and assessing the excise.

## **Total Sales**

Total sales consist of all taxable and non-taxable sales made during the reporting period.

- The reportable sales categories are:
- Sales and transfers out of Massachusetts;
- Sales to export permittees;
- Sales to licensed distributors in Massachusetts;
- Sales to United States Government (only under contract on Form 32 and 33 or authorized purchase orders);
- Other non-taxable distribution;
- Gain or Loss adjustment;
- Net Taxable sales; and
- Taxable gallons consumed or used.

## **Sales and Transfers Out of Massachusetts**

The sales and/or transfer of gasoline outside of the Commonwealth are not taxable. All such transactions are reported on Schedule 6 of the gasoline tax return.

The following must be verified:

- Copies of fuel tax returns filed with other states;
- Delivery tickets;
- Shipping records;
- Delivery point location;
- If customer delivery address differs from billing address;
- The tax rate on out-of-state sales; and
- Schedule 6 entries to taxpayer's books.

## **Sales to Export Permittees**

These sales are reported on Schedule 7 of the gasoline tax return and are not taxable.

The following steps must be performed:

- Review the date of license issuance and renewal;
- Examine purchase order for delivery destination;
- Compare purchase order and delivery ticket destinations;
- Verify that the gasoline scheduled for out-of-state delivery was the quantity actually delivered to that location;
- Check accuracy of Schedule 7 to taxpayer's books;
- Determine if exporter has service station operations in Massachusetts. Gasoline deliveries to a Massachusetts located service station or fuel storage tank are taxable to Massachusetts; and
- Compare Schedule 7 entries to the tax receipts schedule of export permittee.

## **Sales to Licensed Distributors in Massachusetts**

These sales are reported on Schedule 8 of the gasoline tax return and are not taxable. However, if a licensed distributor places gasoline into the tank of a motor vehicle owned/operated by another licensed distributor then the sale is taxable to the distributor making the sales and are not classified as non-taxable reportable in Schedule 8.

The auditor must:

- Verify date of license issuance and renewal;
- Compare Schedule 8 entries of taxpayer to the Schedule 2 entries of the license distributor purchasing the fuel;

- Examine billing invoices as to the quantity of gasoline sold, transferred, or exchanged;
- Check billing invoices for state tax charges; and
- Check date the sale, transfer, or exchange occurred for the correct tax reporting date. Billing date, if any, may not be the same as the date the sale, transfer, or exchanged occurred.

### **Sales to United States government (Bulk)**

These sales are reported on Schedule 9 of the gasoline tax return and are not taxable. However, these sales must be made pursuant to a sales contract executed on United States Forms 32 and 33 or a duly authorized purchase order for gasoline purchased in bulk quantities. The fuel must be invoiced to the United States Government and usually refers to the contract and delivery numbers.

The auditor must:

- Examine contracts with United States Government and check contract dates;
- Check terms of contract for authorized agent signatures, etc.;
- Examine gasoline delivery tickets for address, quantity, and signatures of acquirer;
- Check delivery tickets to billing invoices;
- Match purchase orders to delivery tickets and billing;
- Verify payment was made by United States agency as contract term provides;
- Check sales to contractors working on United States jobs, these are taxable; and
- Ensure that retail sales to United States owned motor vehicles are not included in Schedule 9 but are reported in Schedule 11.

### **United States Government and Foreign Consulate Sales (Retail)**

Sales by the distributor's service station dealers to motor vehicles operated by the United States Government and certain foreign consulates are not taxable and should be reported on Schedule 11.

The following must be verified:

- Sales invoices for date of purchases, purchase name, address, motor vehicle registration, quantity purchased, along with the name and address of dealer;
- Schedule 11 entries to sales invoice for correctness;
- Sales to Consulars must meet provisions outlined by United States Department of State, effective June 1, 1988, and subsequent amendments and procedures outlined in Administrative Procedure 621.3.1;
- Copies of consular tax exemption cards issued by United States State Department for authorized person's name and signature;
- Purchase invoices must be signed only by authorized person;

- Billing of sale must be to the United States agency; and
- Service station dealer reconciliation statements with distributors accounting records for tax credit to dealer for the month the deduction was taken in Schedule 11.

### **Other Non-Taxable Distributions** (Return to Reporting Method)

Such losses are not taxable and should be reported on Schedule 10 of the gasoline tax return.

#### 1. Losses due to theft fire and flood.

The following must be verified:

- Reason reported by the taxpayer for each deduction by reviewing documents relating to the occurrence;
- Police reports for thefts;
- Fire department reports for fire loss;
- Insurance claims;
- Environmental agency reports;
- Fuel control/use records;
- Inventory records;
- Fuel used in equipment;
- Types of company equipment;
- Use records of equipment; and
- Company write-off records including reports to stockholders on major catastrophe cases.

Such sales are not taxable and should be reported on Schedule 10 of the gasoline tax return.

#### 2. Sales to exempt entities are non-taxable.

They include the following:

- Massachusetts Port Authority;
- MWRA;
- MBTA; and
- Transit Authorities.

### **Gain or Loss Adjustment**

Stock loss or gain inherent in storage, transportation and marketing of gasoline is reported on line 15 of the gasoline tax return. This adjustment is restricted to a licensed

distributor. Unclassified importers must pay the excise on the amount imported at the time of importation and not on the sale of gasoline.

The auditor must:

- Prepare schedule of losses and gains;
- Compare losses and gains;
- Note any recurrence of amounts;
- Note seasonal cyclical trends;
- Inquire from taxpayer how gain/loss was determined;
- Analyze gain/loss monthly amounts to ensure that loss amounts less than .005 of gasoline in storage is reasonable. Excess quantity should be questioned; and
- Check purchases for missing unreported receipt of fuel if a large gain is shown.

### **Net Taxable Sales**

The term net taxable sales describes the transactions upon which the excise is imposed. Usually it is that amount of gasoline remaining after the non-taxable categories of distribution as detailed in Schedule 6 - 10 and labeled total non-taxable distribution and "deducted from the amount of total gallons" reported in line 9 of the gasoline tax return.

Taxable sales are verified by the examination which includes:

- Reviewing the Chart of Accounts for revenue and sales accounts;
- Reviewing taxpayer's method of reporting gasoline transactions;
- Reconciling recorded and reported amounts in the books;
- Determining taxable customer accounts;
- Determining how sales are recorded;
- Reviewing billing methods;
- Testing all sales invoices to verify computer codes for accuracy;
- Tracing sales invoices to customer ledger accounts;
- Analyzing all billing invoices in terms of gallons of gasoline;
- Tracing delivery tickets information (gallons/price) to billing amounts and sales journals;
- Comparing daily recaps documents to daily sales reported and accumulated;
- Checking correct tax billing for rate and amount charged accuracy if taxpayer uses tax accrual reporting method;
- Reconciling tax accruals to the amount reported in the tax return;
- Examining general accounts and journals for unusual sales entries;
- Analyzing transfer of gasoline amounts between distributors classified as exchange accounts;
- Requesting audit results/adjustments by other jurisdictions including the IRS where applicable;

- Examining customer purchase orders and tracing to the delivery tickets, sales invoices, customer ledger cards, accounts receivable and customer payment; and
- Obtain explanation for credits issued; check for any credit arising with tax-free delivery of gasoline product.

Sales to unclassified importers from gasoline stored within the Commonwealth are taxable and reported by the distributor; sales from out-of-state, delivered by the taxpayer are taxable and reported by taxpayer; sales by taxpayer from out-of-state, terminal, picked up by the unclassified importer, where title to the gasoline has passed to the importer, is reported by the importer and not by the taxpayer.

### **Taxable Gallons Consumed or Used**

If the taxpayer transfers gasoline into a storage tank for fueling his own or other motor vehicle, that amount so stored is a taxable transaction and reported on line 18 of the gasoline tax return.

The following must be verified:

- Inventory control records for particular storage tank from which gasoline is pumped into motor vehicle tanks;
- Pump daily sheet;
- Meter readings;
- Motor vehicle use records, including odometer readings for accountability of fuel use;
- Fuel sales to motor vehicles owned/operated by others;
- Contractor's accounts for credit entries for fuel sold to contractor as an offset to contractual charges;
- Losses missing from a storage location used to fuel motor vehicles is not allowed; and
- Service station operations for losses which are not allowed on the gasoline tax return but may be refundable by application for refund by the taxpayer.

### **Aviation Gasoline**

Aviation Fuel is included in M.G.L. Chapter 64A, but has a variable tax rate which is updated quarterly by the Excise Unit. The tax rate can be found on the DOR Website which lists the current quarterly rate as well as the historical rates.

All sales of aviation gasoline must be recorded on Form AF-1.

Gasoline Distributors can sell aviation gasoline tax-free as follows:

- Sales to other licensed distributors;

- Sales to licensed exporters provided the whole quantity is shipped outside of Massachusetts;
- Aviation gasoline exported outside of the Commonwealth by a company; and
- Sales to the United States Government and other exempt entities.

Unclassified Importers cannot purchase aviation gasoline tax-free within Massachusetts.

If you are importing aviation gasoline from another state or foreign country, you must file Form AF-1.

If you are a Gasoline Exporter, you can purchase aviation gasoline tax-free in the Commonwealth provided the entire quantity is shipped outside of Massachusetts.

## **Special Fuels Tax Audit Procedures (Supplier)**

### **Introduction**

Chapter 64E of the General Laws imposes a tax on Special Fuels used in the propulsion of Motor Vehicles. A supplier of special fuels, the licensee, files a monthly return (Form SFT-3) accounting for the purchase and disposition of that fuel.

The correctness of the tax return filed by the taxpayer is verified by the auditor whose objective it is to ascertain the proper amount of tax due.

### **Administrative Details**

#### **Identifying Responsible Person(s)**

In order to facilitate the collection of tax liabilities imposed on corporations and partnerships by MGL chapters 62B, 64G, 64H and 64I, auditors must identify the responsible person(s) who are liable for such trustee taxes pursuant to M.G.L. chapter 62C, section 31A and Regulation 830 CMR 62C.31A.1.

The identification of responsible persons must be done for all trustee tax audits. Auditors must document in the audit narrative and Audit WorkBench (AWB)-Case Log the names of the individual(s) responsible for paying over the trustee taxes. This information must also be entered into the MASSTAX system under the taxpayer "NOTE" screen.

#### **Bank Account Information**

During the course of the examination, the auditor must gather the following information relating to the taxpayer's banking activity:

- Name of bank(s) in which the taxpayer has account(s); and

- Account(s) numbers.

If the taxpayer has more than three (3) accounts, the auditor must get the above information for the taxpayer's three primary accounts. The information must be noted in the audit narrative and documented in the MASSTAX system under the taxpayer "NOTE" screen.

## **Bankruptcy Information**

When a taxpayer files the bankruptcy case, the automatic stay prohibits all of the taxpayer's creditors, including the Department of Revenue, from taking any action to collect any debts or liabilities that relate to the time period before the Petition Date.

During the course of the initial taxpayer contact, the auditor should ask the taxpayer if they are in bankruptcy. If the taxpayer is in bankruptcy, the auditor must obtain the following information and forward it to the Litigation Bureau's Bankruptcy Unit immediately:

- The location of the Bankruptcy Court;
- The Bankruptcy Court docket number (stamped on the bankruptcy petition); and
- The petition date (the date the bankruptcy case was filed).

The information must be noted in the audit narrative and Audit WorkBench (AWB) - Case Log to ensure the necessary steps are taken to contact the Bankruptcy Unit in a timely fashion.

**Note: Bankruptcy procedures are discussed in detail within Chapter 6-Specialized Audit Procedures of the Field Audit Procedures Manual.**

## **Preliminary Research**

Prior to the "field" audit the auditor should perform a review of the following:

- Taxpayer's license application, if available (Form SFT-1);
- Tax returns filed for the period under audit;
- Taxpayer's prior audit history; and
- Review of prior audit if any; request the audit folder from the Records Management Bureau.

## **Field Review**

Upon completion of the above review, the auditor is now ready to perform a field audit. The following documents should be examined to verify the accuracy of the tax returns filed:

- All journals and ledgers which relate to entries made on the tax return;

- Daily fuel control sheets;
- Work papers and schedules used to prepare the tax returns; and
- Any other records which the taxpayer maintains that may be useful in the final audit determination.

## **Reporting Categories**

The supplier's tax return consists of the following categories:

- Inventories and Receipts
- Disposition
- Type of Special Fuel
- Schedule A - Bulk Purchases (Both in-state and out-of-state)
- Schedule B - Taxable Gallons Placed or Used in Own or Leased Registered Motor Vehicles
- Schedule C - Taxable Gallons Sold to Other Users
- Schedule D - Taxable Gallons Sold to User-Sellers, including company's own stations (Bulk Sales)
- Schedule E - Non-Taxable Gallons Sold or Used
- Own use;
- Sales to others (sales to licensed Suppliers, sales of home heating oil, sales for non- registered equipment, etc.); and
- Transfers out-of-state (additional schedule insert - Part C).

## **Inventories and Receipts**

The auditor must verify the accuracy of inventory items as reported in this section. Gallons purchased must agree with amounts reported on Schedule A.

## **Disposition**

Line items in this section must be verified to determine the accuracy of the corresponding schedules.

### **Schedule A**

#### **Bulk Purchases**

Purchases should be verified for accuracy. The auditor must review Purchase Journal and invoices from suppliers as a check against the amounts reported.

### **Schedule B**

Taxable Gallons Placed or Used in Own or Leased Registered Motor Vehicles.

If the taxpayer operates motor vehicles the examination of the records may start with checking the taxpayer's use as reported in Schedule B.

The following should be verified:

- Fueling records;
- Pump readings;
- Driver logs;
- Trip records;
- Mileage records; and
- Odometer readings.

The auditor should take note of all possible internal use of fuel by the taxpayer. This may require obtaining all of the trucking and other activities involving use of motor vehicles, and other equipment. For instance, determine how non-highway, unregistered equipment is transported and where it is working.

### **Schedule C**

Taxable Gallons Sold to Other Users (Fuel Placed in Registered Motor Vehicles Only)

All sales reported on Schedule C should be verified as follows:

- Check pump meter readings;
- Review customer billing and accounts receivable;
- Verify cash sales records; and
- Exam sales invoices.

Note infrequent sales or small amounts of fuel sold by the taxpayer which may represent only a partial list of sales to a customer.

### **Schedule D**

Taxable Gallons Sold to User-Sellers (Bulk Sales). Companies that drop into their own stations should also be reported on this schedule.

All sales reported on Schedule D are taxable and proper examination of taxpayer's books should be performed to verify amounts reported.

### **Schedule E**

Non-Taxable Gallons Sold (Sales to licensed Suppliers or sold for use in non-registered equipment or transferred out-of-state or used in the company's own non-registered equipment).

Gallons reported on Schedule E are not taxable. The auditor should complete a thorough review of all gallons listed on this schedule. Some of these gallons may be subject to a sales/use tax.

### **Special Fuels (User-Seller)**

The main purpose of this audit is to verify that all special fuel purchased has been paid to their supplier and that the supplier has in turn remitted such tax to the Commonwealth on their monthly Form SFT-3.

The taxpayer files Form SFT-4, User-Seller's Special Fuels Tax Return, on a monthly basis, reporting the names of its suppliers and accounting for its fuel purchases.

At the outset of the audit, the auditor should check all storage tanks and meter readings. The auditor should then obtain a list of all registered and non-registered equipment.

Next, the auditor should check Accounts Payable in order to ensure that the proper amount of tax was charged by the oil company. This can usually be verified from purchase invoices and accounts payable journals. Since M.G.L. Chapter 64E does not mandate that the Special Fuels tax be stated on the purchase invoice, the auditor may also need to obtain the oil company's Form SFT-3 from the Records Management Bureau in order to verify that the tax was properly remitted to the Commonwealth. The auditor should also verify that all purchases have been made from a licensed supplier.

Accounts Payable and Cash Disbursements should be thoroughly review to determine if any other fuel purchases (diesel, home heating oil, kerosene or propane) were made and used in registered equipment.

### **Liquefied Gases (Propane and Compressed Natural Gas)**

Liquefied gases such as propane and compressed natural gas are reported on a separate insert to the SFT-3 titled Schedule LG. These rates are also variable and are updated each quarter on the DOR Website by the Excise Unit. (Liquefied gas is that type of Special Fuel which is a combustible gas and exists in a gaseous state at a temperature of 60° Fahrenheit and a pressure of 14.7 pounds per square inch absolute).

### **Jet Fuel Tax**

The Jet Fuel (Aircraft Fuel) Tax is a local option tax enacted by a city or town and is imposed by M.G.L. Chapter 64J which is collected (and audited) by the Department of Revenue (DOR). The money is not part of the general fund, but is remitted by DOR directly to the taxing city or town. Suppliers and User- Sellers of Jet Fuel must submit license application Form JFT-1 (no fee) initially and renew by the first of January each year.

All licensed suppliers must file Form JFT-4S and user-sellers of jet fuel must file Form JFT-4-U on or before the 20th day of each month following the month of sales or use. A listing of which municipalities have enacted this local option may be obtained from the Excise Unit. If a new city or town enacts the Jet Fuel tax, the Excise Unit will notify supplier and user-sellers of record.

The Jet Fuel tax is also a variable tax and is updated on a quarterly basis on the DOR Website by the Excise Unit.

## **Underground Storage Tank Program**

Any person who maintains an underground storage tank (10% or more of the tank volume and piping is buried below the ground surface) located in Massachusetts and dispenses petroleum products directly into motor vehicles is responsible for collecting a delivery fee of \$0.0025 per gallon and remitting the same on a monthly basis (UST Form 500) to the Department of Revenue. The delivery fee shall be applicable to deliveries made on or after April 1, 2003 in accordance with Regulation 503 CMR 4.00.

Each owner of an underground storage tank which is used to store petroleum products at a Dispensing Facility must a \$250.00 annual tank fee for the benefit of the fund which is due June 1st of each year. The Underground Storage Tank Petroleum Cleanup Fund was established to assist with cleanup of contaminated areas which fees are regulated by M.G.L. Chapter 21J.

A petroleum product is obtained from distilling and processing crude oil and is capable of being used as fuel for the propulsion of a motor vehicle or aircraft. The term does not include naphtha-type jet fuel, kerosene-type jet fuel, petroleum product destined for use in chemical manufacturing or feedstock of that manufacturing or fuel oil used for heating purposes.

Although the New England Audit Bureau is not responsible for either the filing or auditing of UST Form 500, the returns can be used as a tool to trace motor fuels from the wholesale to the retail level.

## **IFTA Audit Procedures**

### **Introduction**

M.G.L. Chapter 64F imposes a tax of fuel and special fuels acquired outside and used within the Commonwealth of Massachusetts. Therefore, a motor carrier is any person who uses or operates a motor vehicle for commercial or business purposes using fuel purchased outside Massachusetts on Massachusetts highways. All such vehicles using Massachusetts highways must have (1) a Motor Carrier License; (2) a Motor Carrier Tax Vehicle License, and (3) if the vehicle is propelled by a "special fuel", a "User of Special Fuel" License (See 830 CMR 64F.6.1).

IFTA is the International Fuel Tax Agreement which is an agreement between the United States and the Canadian Provinces. Each IFTA motor carrier selects a base state or base jurisdiction which collects motor fuel taxes on qualified motor vehicles for its own jurisdiction and other IFTA jurisdictions then distributes the appropriate taxes to these jurisdictions.

Motor carriers licensed under the International Fuel Tax Agreements whose base state is Massachusetts shall file a calendar quarterly report for the previous calendar quarter with the Commissioner. The timely filing of the quarterly returns and payment of taxes due to the Commonwealth for all Member Jurisdictions discharges the responsibility of the licensee for the filing of reports and the payment of individual taxes to all Member Jurisdictions.

## **Administrative Details**

### **Identifying Responsible Person(s)**

In order to facilitate the collection of tax liabilities imposed on corporations and partnerships by MGL chapters 62B, 64G, 64H and 64I, auditors must identify the responsible person(s) who are liable for such trustee taxes pursuant to M.G.L. chapter 62C, section 31A and Regulation 830 CMR 62C.31A.1.

The identification of responsible persons must be done for all trustee tax audits. Auditors must document in the audit narrative and Audit WorkBench (AWB)-Case Log the names of the individual(s) responsible for paying over the trustee taxes. This information must also be entered into the MASSTAX system under the taxpayer "NOTE" screen.

### **Bank Account Information**

During the course of the examination, the auditor must gather the following information relating to the taxpayer's banking activity:

- Name of bank(s) in which the taxpayer has account(s); and
- Account(s) numbers.

If the taxpayer has more than three (3) accounts, the auditor must get the above information for the taxpayer's three primary accounts. The information must be noted in the audit narrative and documented in the MASSTAX system under the taxpayer "NOTE" screen.

### **Bankruptcy Information**

When a taxpayer files the bankruptcy case, the automatic stay prohibits all of the taxpayer's creditors, including the Department of Revenue, from taking any action to collect any debts or liabilities that relate to the time period before the Petition Date.

During the course of the initial taxpayer contact, the auditor should ask the taxpayer if they are in bankruptcy. If the taxpayer is in bankruptcy, the auditor must obtain the following information and forward it to the Litigation Bureau's Bankruptcy Unit immediately:

- The location of the Bankruptcy Court;
- The Bankruptcy Court docket number (stamped on the bankruptcy petition); and
- The petition date (the date the bankruptcy case was filed).

The information must be noted in the audit narrative and Audit WorkBench (AWB) - Case Log to ensure the necessary steps are taken to contact the Bankruptcy Unit in a timely fashion.

Note: Bankruptcy procedures are discussed in detail within **Chapter 6-Specialized Audit Procedures** of the Field Audit Procedures Manual.

## **IFTA Requirements**

An IFTA motor carrier is any person who uses or operates an IFTA qualified motor vehicle for commercial or business purposes on Massachusetts highways and the highways of at least one other International Fuels Tax Agreement (IFTA) jurisdiction.

An IFTA qualified motor vehicle is a vehicle other than a recreational vehicle, that is used, designated or maintained for the transportation of persons or property and that (i) has two axles and a gross vehicle weight or registered weight exceeding 26,000 pounds; (ii) has three or more axles on the power unit, regardless of weight; or (iii) is used in combination and the combined gross vehicle weight or registered gross vehicle weight exceeds 26,000 pounds. IFTA motor carriers must register and file returns with their base jurisdiction for activity in all IFTA jurisdictions. All such qualified vehicles using Massachusetts highways must have (1) an IFTA license and (2) two IFTA decals.

The International Fuel Tax Agreement reduces the compliance burden for motor fuel use tax reporting because:

- The motor fuel use tax licenses issued by the base jurisdiction authorizes travel in all member jurisdictions;
- IFTA tax reports submitted to the base jurisdiction detail operations in all IFTA jurisdictions and reflect net tax due or overpayments for all jurisdictions; and
- IFTA audits are, in most cases, performed only by the base jurisdiction.

## **License Applications**

IFTA motor carriers based in Massachusetts must file license application Form IFTA-1 initially and must renew licenses no later than every January 1st. There is a grace period through the end of February if your vehicle still displays the prior year's decals. Owner-operators may use a Social Security Number. All other applicants are required to

use a Federal Identification Number. Two IFTA decals which can be issued only by the DOR through the mail must be affixed to each vehicle.

## **Filing Requirements**

IFTA motor carrier tax licensees are required to file IFTA Quarterly Fuel Use Tax Reports (Form IFTA 100 and 101) by the last of the month following the close of the quarter, even if no tax is due. If a licensee's status has changed and is no longer an IFTA qualified motor carrier, the IFTA license and both IFTA decals must be returned to the DOR with a letter requesting cancellation, indicating the effective date.

## **Tax Rates**

Current tax rates can be found at **[www.IFTACH.org](http://www.IFTACH.org)**. Member jurisdictions provide the tax rate information to IFTA, Inc. IFTA, Inc. was established to assist the Member Jurisdictions in their administration of the International Fuels Tax Agreement (IFTA). Each member jurisdiction is responsible for the information reported to IFTA, Inc. and posted on the web page. Additionally, each Member Jurisdiction is responsible for updating the information reported by them to assure that it remains accurate.

## **Records**

The licensee is required to preserve the records upon which the quarterly tax return or annual tax return is based for four years from the tax return due date or filing date, whichever is later, plus any time period included as a result of Form A-37 (waivers) or jeopardy assessments.

Failure to provide records requested will extend the four year record retention requirement until the records are presented for audit purposes.

Failure to comply with maintaining records as required may show cause for revocation of the license. The base jurisdiction has the authority to defer license revocations if the licensee demonstrates evidence of compliance for future operations.

## **Exemptions (Massachusetts Turnpike)**

Fuel used on any turnpike constructed by the Massachusetts Turnpike Authority is exempt. For travel on the Massachusetts Turnpike on or after April 1, 1998, IFTA licensees may take the Massachusetts Turnpike exemption for IFTA qualified vehicles only on the IFTA consolidated return. Turnpike miles are to be included in total IFTA miles (Column H of IFTA-101) and excluded from taxable miles on the IFTA return (Column I of IFTA-101) for travel in Massachusetts. IFTA carriers may not make separate applications for Turnpike refunds using the Massachusetts Department of Revenue's Special Fuel and/or Gasoline Refund Application for IFTA qualified vehicles travel occurring on or after April 1, 1998.

Motor fuel for which the Turnpike exemption is taken is subject to the 6.25% Use Tax imposed by M.G.L. Chapter 64I, section 2. Registrants are required to file an annual Massachusetts Business Use Tax Return (ST-10) and remit the 6.25% Use Tax on the cost of the fuel for which the exemption was taken. The return is due with payment on or before April 15th, for purchases made in the prior calendar year.

### **IFTA Governing Documents**

The provisions of the three IFTA documents are equally binding upon the Member Jurisdictions and IFTA licensees. The three (3) IFTA governing documents are:

- The IFTA Articles of Agreement;
- The IFTA Audit Procedures; and
- The IFTA Procedures Manual.

The IFTA Articles of Agreement, the IFTA Audit Procedures and the IFTA Procedures Manual can be found at **[www.IFTACH.org](http://www.IFTACH.org)**.